

BY EMAIL

Directorate General Internal Market and Services
European Commission
B – 1049 Brussels
Belgium

8 December, 2010

Re: Green Paper -
Audit Policy: Lessons from the Crisis ('the Paper')

Dear Sir/Madam,

Remit of the Irish Auditing and Accounting Supervisory Authority ('IAASA')

IAASA is a statutory body¹ whose principal functions include:

- supervising the regulatory and monitoring activities of nine Prescribed Accountancy Bodies² whose aggregate membership in the State exceeds 28,000³;
- as a competent authority under the European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010 ('Statutory Audit Directive Regulations'), discharging responsibilities relating, *inter alia*, to:
 - public oversight;
 - registration and quality assurance of third country auditors; and
 - international co-operation, including authorisation of the transfer of working papers to third countries' audit regulatory authorities;
- as a competent authority under the Transparency (Directive 2004/109/EC) Regulations 2007 ('the Transparency Regulations'), monitoring certain issuers' periodic financial reporting for compliance with relevant reporting frameworks; and

¹Established pursuant to the Companies (Auditing and Accounting) Act 2003

²The nine Prescribed Accountancy Bodies are the:

- Association of Chartered Certified Accountants (ACCA)
- Association of International Accountants (AIA)
- Chartered Institute of Management Accountants (CIMA)
- Chartered Institute of Public Finance & Accountancy (CIPFA)
- Institute of Certified Public Accountants (ICPAI)
- Institute of Chartered Accountants in England & Wales (ICAEW)
- Institute of Chartered Accountants in Ireland (ICAI)
- Institute of Chartered Accountants of Scotland (ICAS)
- Institute of Incorporated Public Accountants (IIPA)

³The aggregate membership of the PABs resident in the State as at 31 December, 2009 stood at 28,547, as set out in IAASA's 2009 Annual Report

- acting as a specialist source of advice to the Ministers for Enterprise, Trade & Innovation and Trade & Commerce respectively on auditing, accounting and related matters.

IAASA is also a member of both the EGAOB⁴ and IFIAR⁵.

Given IAASA's statutory remit, the Paper is of considerable interest and IAASA, therefore, welcomes the opportunity to comment on the issues set out therein.

Context – the Irish banking crisis and the principal responses to same to date

The opening paragraph of the Paper states that:

'The fact that numerous banks revealed huge losses from 2007 to 2009 on the positions that they had held both on and off balance sheet raises not only the question of how auditors could give clean audit reports to their clients for those periods but also about the suitability and adequacy of the legislative framework'.

In that context, it is considered appropriate to set IAASA's comments in context by providing an overview of the Irish banking crisis, its impact on confidence in financial reporting and audit respectively and the principal responses to same that have to date been taken.

To date, the Irish Government has, *inter alia*, considered it necessary to:

- guarantee the liabilities of certain financial institutions;
- take a number of institutions, including Anglo Irish Bank Corporation Limited, into public ownership;
- provide exceptional Exchequer support, in the form of recapitalisation, to a number of financial institutions; and
- establish a National Asset Management Agency to acquire certain elements of specified financial institutions' loan books.

The Government has, further, commissioned two preliminary reports on matters relating to the crisis, viz:

- 'Preliminary Report on the Sources of Ireland's Banking Crisis' ('the Regling/Watson Report')⁶; and
- 'The Irish Banking Crisis - Regulatory and Financial Stability Policy 2003 – 2008' ('the Honohan Report')⁷.

Having received and considered the aforementioned reports, the Government has further established a Commission of Investigation into the Banking Sector in Ireland ('the Banking Commission'), whose work is currently ongoing with an anticipated completion date of early 2011.

⁴ European Group of Auditors' Oversight Bodies

⁵ International Forum of Independent Audit Regulators

⁶ Authored by Herr Klaus Regling and Mr. Max Watson, the Regling/Watson Report can be accessed at <http://www.bankinginquiry.gov.ie/Preliminary%20Report%20into%20Ireland's%20Banking%20Crisis%2031%20May%202010.pdf>

⁷ Authored by Professor Patrick Honohan, Governor of the Central Bank of Ireland, the Honohan Report can be accessed at <http://www.bankinginquiry.gov.ie/The%20Irish%20Banking%20Crisis%20Regulatory%20and%20Financial%20Stability%20Policy%202003-2008.pdf>

Regling/Watson Report

As set forth in the Executive Summary to same, the principal findings and conclusions of the Regling/Watson Report include the following:

- while Ireland's banking crisis bears the clear imprint of global influences, it was, in crucial ways, 'home-made';
- in the run up to Ireland's crisis, global financial markets featured an extended period of high growth and low risk premia. Monetary conditions in the euro area were also easy relative to the levels of growth and inflation in Ireland. Financial integration in the euro area was deepening and banks in Ireland had unprecedented access to cross-border funding. As in many smaller EU countries, the entry of foreign banks intensified competition in lending;
- against this backdrop, Ireland experienced a strong and extended domestic financial boom, accompanied by an influx of foreign savings. This boom needs to be seen in the context of Ireland's strong and extended expansion during the previous decade, during which the economy caught up with, and surpassed, average EU living standards. This fostered expectations of a continued rise in living standards and in asset values;
- another factor, with even deeper roots, was the strong and pervasive preference in Irish society for property as an asset. This factor was magnified by the fact that Ireland had never suffered a property crash of this severity since independence;
- official policies and banking practices in some cases added fuel to the fire and fiscal policy, bank governance and financial supervision left the economy vulnerable to a deep crisis;
- bank governance and financial supervision faced major challenges. Banks had operated over the previous decade in a setting of greatly increased wholesale funding opportunities following the adoption of the euro and banks from abroad began to compete strongly in retail mortgage lending. Against this backdrop, strongly risk-averse reactions by banks in Ireland and their supervisors would have been needed to help dampen what has transpired to be a very risky boom-bust cycle;
- bank governance and risk management were weak – in some cases disastrously so. This contributed to the crisis through several channels. Credit risk controls failed to prevent severe concentrations in lending on property – including, notably, on commercial property – as well as high exposures to individual borrowers and a serious overdependence on wholesale funding. It appears that internal procedures were overridden, sometimes systematically;
- there is a need to probe more widely the scope of governance failings in banks, whether they were of a rather general kind or (apparently in far fewer instances) connected with very serious specific lapses, and whether the auditors were sufficiently vigilant in some episodes;
- bank supervisors in Ireland were not called upon to deal with technically complex problems. Ireland's banking exuberance indulged in few of the exotic constructs that caused problems elsewhere. Rather, this was a plain vanilla property bubble, compounded by exceptional concentrations of lending for purposes related to property – and notably commercial property;
- it is clear that, in various ways, official policies and bank governance failings seriously exacerbated Ireland's credit and property boom and depleted its fiscal and banking buffers when the crisis struck;
- the true burden of responsibility emerges as quite broad and it extends to insufficiently critical external surveillance institutions.

As is clear from the foregoing, the Regling/Watson Report does not attribute culpability for the crisis to the audit profession. That report does, however, conclude that there is a need to probe more widely into whether auditors were sufficiently vigilant in some episodes. The basis for this conclusion is elaborated upon in the body of the Report as follows:

- *'As a broad generalisation, the failings of corporate governance seem to have been much more a problem of deficient implementation than defective guidelines and processes. With strong roles of boards, credit committees, audit committees, and external auditors, common sense suggests that any systematic problems of this kind in an institution should have been picked up'*⁸;
- *'A fourth and final set of issues is potentially much graver, and it cannot be assumed they constituted generalised phenomena. There were very specific and serious breaches of basic governance principles concerning identifiable transactions that went far beyond any question of poor credit assessment. The Government's notice on the nationalisation of Anglo Irish Bank, for example, refers to 'unacceptable corporate governance practices' as a triggering factor in the nationalisation. The preparations for this report did not unearth additional examples beyond those already in the public domain. Some investigations are already underway, and are therefore not commented on here. Relevant categories of such potential issues seem to include the disclosure of loans to directors; the window-dressing of balance sheets beyond acceptable levels; and the question whether loans by financial institutions were linked in some clear and problematic way to purchases of their own shares. One question is whether the possibility of market manipulation (in the share market) as a specific concern may deserve consideration. In some of these areas, again, there may be questions as to how far external auditors probed relevant draft accounts before certifying them. But, to be quite clear, there is no suggestion here that such grave breaches were a generalised feature of the Irish financial system. It seems that they were limited to, at most, specific institutions'*⁹.

The Regling/Watson Report concludes by recommending that, amongst others, matters warranting further investigation by the Banking Commission include *'...whether there were failures of auditorial vigilance'*¹⁰.

The Honohan Report

Whilst the Honohan Report's focus is on regulatory and financial stability policy over the period 2003 to 2008, it does make a number of comments and observations regarding the auditing profession. For completeness, those comments and observations are set out hereunder:

- *'It may be the case that auditors and accountants should have been more alert to weaknesses in the banks' lending and financial position. While these aspects have not been independently researched for this Report, they merit further investigation'*¹¹;
- *'Although there were no warning signals coming from the institutions' auditors/accountants, anecdotal evidence suggests that some of these elements [i.e., undercapitalisation and rapid balance sheet growth] were starting to occur'*¹².

⁸ Page 35 refers

⁹ Page 35 refers

¹⁰ Page 45 refers

¹¹ Page 7 refers

¹² Page 80 refers

Banking Commission

As outlined above, the Banking Commission's terms of reference were set by Government subsequent to receipt of the Regling/Watson and Honohan Reports. The Commission has been:

'...established to investigate the following specific matters considered by the Government to be of significant public concern and requiring, in the public interest, an expedited examination of:

- a) the main causes of the serious failure, during the period 1 January 2003 to 15 January 2009, within each of the covered institutions¹³, to implement and adhere to, appropriate standards and controls (including checks and balances) in the context of corporate governance and prudent risk management policy and procedures such as would have avoided the requirement for the provision of exceptional financial support from the State;*
- b) the main causes for the adoption, during the period 1 January 2003 to 15 January 2009, by the Boards of Anglo Irish Bank Corporation and Irish Nationwide Building Society of business models and strategies, and the implementation by the senior managements of those institutions of business and lending practices, which resulted in those institutions experiencing severe financial stress;*
- c) whether in respect of the period 1 January 2003 to 15 January 2009 the external auditors of the covered institutions commented in their audit reports or other communications to the institutions concerned on the failures referred to in subparagraph (a) or the business models and strategies and business and lending practices referred to in subparagraph (b);*
- d)¹⁴.*

As indicated above, at this time the Banking Commission's work is ongoing, with its Report expected in early 2011.

Legislative responses

In response to the banking crisis, the Government has enacted legislation the effect of which has been, amongst other things, to reconstitute the Central Bank of Ireland and confer that organisation with enhanced regulatory powers and responsibilities.

Regulatory responses – areas of relevance to IAASA's remit

Under IAASA's close supervision, and consistent with the model of supervised self regulation provided for under Irish law, the Institute of Chartered Accountants in Ireland ('the Institute') has appointed a Special Investigator to examine the role that any of its members may have played in events at Anglo Irish Bank Corporation¹⁵. At this time, the foregoing exercise is in progress.

¹³ Pursuant to Ministerial Orders made on 24 October and 5 November, 2008 respectively, the following credit institutions and subsidiaries are 'covered institutions' for the purposes of the Credit Institutions (Financial Support) Scheme 2008:

1. Allied Irish Banks plc and its subsidiaries AIB Mortgage Bank, AIB Bank (CI) Limited, AIB Group (UK) plc and Allied Irish Banks North America Inc.;
2. Anglo Irish Bank Corporation plc and its subsidiary Anglo Irish Bank Corporation (International) plc;
3. The Governor and Company of the Bank of Ireland and its subsidiaries Bank of Ireland Mortgage Bank, ICS Building Society and Bank of Ireland (IOM) Limited;
4. EBS Building Society and its subsidiary EBS Mortgage Finance;
5. Irish Life & Permanent plc and its subsidiary Irish Permanent (IOM) Limited;
6. Irish Nationwide Building Society and its subsidiary Irish Nationwide (IOM) Limited; and
7. Postbank Ireland Limited.

¹⁴ Statutory Instrument No 454 of 2010

¹⁵ The Special Investigator's mandate is to investigate possible breaches of Institute Bye-Laws and Rules of Professional Conduct by its members/member firms relating, *inter alia*, to the following:

- certain loans made by Anglo Irish Bank and relevant members' roles in that regard;

Similarly, in its capacity as the competent authority for monitoring certain issuers' periodic financial reporting for compliance with relevant reporting frameworks, IAASA has devoted considerable resources to examining relevant constituent entities' financial reporting.

Criminal investigations

Certain of the abovementioned issues have also led to the initiation of criminal investigations, which are also ongoing at this time.

Effect of the banking crisis on public confidence in Irish financial institutions' corporate reporting and in the Irish audit profession

The factors referenced in the Regling/Watson Report have resulted in Irish financial institutions subsequently reporting catastrophic losses – which, in a number of well documented instances have resulted in the need for nationalisation and other forms of State support – immediately following a sustained period during which those same institutions reported substantial profits.

This dramatic swing in reported results and financial soundness over such a short timeframe, when combined with certain institution-specific revelations, has given rise to suggestions that financial reporting in the sector has been unreliable, misleading or perhaps even fraudulent. In addition, by virtue of having provided unqualified opinions in respect of reporting periods:

- immediately preceding the reporting of the aforementioned losses; and
- during which certain practices and transactions have subsequently emerged as having occurred,

concerns have also been expressed regarding the performance of the audit profession. The result has been a significant loss of public confidence in both Irish financial institutions' financial reporting and in the audit profession.

Factors contributing to the loss of public confidence

A more detailed analysis would suggest that one or more of the following factors have contributed to the aforementioned loss of confidence:

- i. a financial reporting expectation gap, i.e., a gap between the information provided by historical, general purpose financial statements and public expectations in that regard. In the Irish context, a prime example of where such a gap has arisen has been commentators' expectations as to how expected loan losses might be reported and the approach mandated by IFRS, as adopted for use in the EU, towards the reporting of such losses;
- ii. an audit expectation gap, i.e., a gap between the purpose of statutory audit, as provided for by law and professional standards, and public expectations in this regard. In the Irish context the audit expectation gap has manifested itself through the differences between the scope and purpose of statutory audit as laid down by the Companies Acts and ISAs (UK and

-
- certain deposits made between Anglo Irish Bank and the Irish Life & Permanent Group and relevant members' roles in that regard; and
 - the performance of the bank's auditors with regard to certain of the foregoing.

Ireland) and stakeholders' apparent expectations as to what an unqualified audit opinion means in the context of, for example:

- a. the audited entity's business model;
 - b. the quality of the audited entity's management, governance and risk management; and
 - c. the audited entity's future financial health and prospects;
- iii. a perception that financial statements and/or other public documents containing financial information, have been materially misstated, intentionally or otherwise; and
 - iv. a perception that auditors have failed to properly discharge their duties by not drawing attention at an earlier juncture to issues that have subsequently come to light.

Whilst, as outlined above, the matters encompassed by (iii) and (iv) above are, or have been, the subject of a range of regulatory responses, it is clear that, irrespective of whether the:

- financial reports in question have been prepared in full compliance with the relevant reporting frameworks; and/or
- audits in question have been performed in full compliance with applicable law and professional standards,

the current model of financial reporting and audit has not met public expectations in an Irish context and has, as a consequence, been brought into disrepute. For that reason, and given that:

- legislation governing statutory audit is primarily set at EU level; and
- financial reporting and auditing standards are both set internationally,

IAASA agrees with the Commission's analysis that it is appropriate that both the role and scope of audit be examined in the context of the wider financial market regulatory reform currently underway.

IAASA further notes that, in addition to discussing the topics of the role and scope of audit as currently formulated, the Commission has taken the opportunity presented by the Paper's publication to discuss, and seek stakeholders' views on, the issue of market concentration.

Characteristics of any reform resulting from this consultation exercise

IAASA agrees with the Commission's analysis that any reform resulting from this consultation exercise should be proportionate to the scale and attributes of both the audit firms and audited entities concerned. IAASA is further of the view that, rather than merely using a traditional 'listed entities versus non-listed entities' basis for distinguishing between audited entities (and, by extension, the audits/auditors of same), there may be merit in seeking to distinguish audited entities (and, by extension, their audits and auditors) by reference to whether those entities are systemically important to a Member State's economy (or to the economy of the European Union overall). In an Irish context, and by reference to the material set out under 'Context' above, it is suggested that certain of Ireland's financial institutions would fall into the category of being systemically important in the context of the State's economy and may, therefore, merit a different approach to that taken in respect of other, non-systemically important, listed entities.

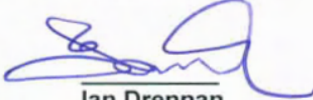
Responses to questions posed

IAASA's responses to the specific questions posed in the Paper are set out in the Appendix to this letter.

Closing remarks

It is IAASA's hope that this submission will be of assistance to the Commission's deliberations. Should any clarification be considered helpful in that regard, please contact the undersigned.

Yours sincerely,



Ian Drennan
Chief Executive

RESPONSES TO SPECIFIC QUESTIONS POSED IN THE PAPER

Question 1

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

Response

As set out in the covering letter, IAASA agrees with the Commission's analysis that it is appropriate that both the role and scope of audit be examined in the context of the wider financial market regulatory reform currently underway. In that context, the introductory section of the Paper sets out many of the issues that should be considered in any such examination. It is noted, however, that the introductory section of the Paper makes no reference to:

- the responsibilities of those charged with governance¹⁶ to govern in an appropriate manner and to prepare financial statements that give a true and fair view of reporting entities' profits/losses and financial positions (although it is acknowledged that the introductory section of the Paper does cross-refer to the Green Paper on corporate governance in financial institutions); or
- IFRS, as adopted for use in the EU, and the extent to which its approach towards, for example, the reporting of loan loss impairments may have contributed to audited financial reporting not meeting public expectations and the resultant loss of confidence in both financial reporting and the audit profession.

It is suggested that any analysis of the existing model of audited financial reporting should consider not only the role of statutory audit and the auditor but should also extend to considering relevant aspects of financial reporting and Board members' responsibilities.

Question 2

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

Response

Under statutory audit as presently constituted, statutory auditors report in the first instance to the audited entity's shareholders. In Ireland, this primary reporting obligation is supplemented by a range of associated statutory reporting obligations, for example to prudential supervisors as well as to the tax authorities and certain civil and criminal law enforcement authorities. Such reporting obligations typically arise in circumstances where the auditor identifies indications of non-compliance with specified law or regulations.

Recent events in Ireland have clearly demonstrated that a range of other stakeholders, up to and including the population as a whole, have a legitimate interest in the truth and fairness of certain systemically important entities' financial reporting and in the audit of same. That being the case, IAASA is of the view that there is merit in considering a redefinition of auditors' societal role, such that statutory auditors – perhaps limited to the audits of systemically important entities – would have a greater degree of latitude (or, indeed, a requirement in certain instances) to report matters of a public interest nature (i.e., not merely matters suggesting non-compliance with law and regulations) to appropriate authorities (which, in certain instances, might be the public).

¹⁶ Given the context, the term 'those charged with governance' should, for the purpose of this submission, be taken to include the Audit Committee.

It is submitted that auditors should also be under an obligation to co-operate where relevant authorities initiate investigations on foot of auditors' reports.

Clearly, however, any additional latitude (or responsibility) would give rise to increased litigation and financial risks which would require the provision of appropriate mitigating measures.

In the context of the foregoing, it is noted that, whilst Directive 2006/43/EC ('the Directive')¹⁷ contains a number of provisions dealing specifically with the audit of public interest entities (i.e. in the areas of transparency reports, audit committees, quality assurance and certain additional independence requirements), the only reference in the Directive to the public interest in the execution of audits is contained in Article 21(1), which provides that:

'Member States shall ensure that all statutory auditors and audit firms are subject to principles of professional ethics, covering at least their public-interest function'.

It would seem, therefore, that there may be scope for expressly providing that, at a minimum for certain classes of audits, auditors may/should have regard to certain specified considerations in determining whether public interest reports ought/should be made to the appropriate authorities.

In an Irish context, ISA (UK and Ireland) 250 (Section B – The Auditor's Right and Duty to Report to Regulators in the Financial Sector)¹⁸ is of some relevance in this regard. Paragraph 15 of that standard provides that:

'When a matter comes to the auditor's attention which the auditor concludes does not give rise to a statutory duty to report but nevertheless may be relevant to the regulator's exercise of its functions, the auditor shall:

- a) consider whether the matter should be brought to the attention of the regulator under the terms of the appropriate legal provisions enabling the auditor to report direct to the regulator; and, if so*
- b) advise those charged with governance that in the auditor's opinion the matter should be drawn to the regulator's attention.*

Where the auditor is unable to obtain, within a reasonable period, adequate evidence that those charged with governance have properly informed the regulator of the matter, the auditor shall make a report direct to the regulator as soon as practicable'.

Paragraph A36 of the same standard observes that:

- the auditor may become aware of matters which s/he concludes are relevant to the exercise of the regulator's functions even though they fall outside the statutory definition of matters which must be reported to a regulator;
- in such circumstances relevant UK legislation provides the auditor with protection for making disclosure of the matter to the appropriate regulator - there is, however, no statutory provision of protection for a voluntary report under relevant legislation in Ireland.

Whilst the foregoing text is based on auditors' statutory reporting obligations, and deals with auditors' right to report certain matters to regulators within the parameters of relevant legislation, it could possibly be used as a starting point for creating a right on the part of auditors to report public interest

¹⁷ Transposed into Irish law by the European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010

¹⁸ [http://www.frc.org.uk/images/uploaded/documents/ISA%20\(UK%20and%20Ireland\)%20250%20-%20Section%20B%20\(final\).pdf](http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20250%20-%20Section%20B%20(final).pdf)

matters to appropriate authorities even in circumstances where such matters do not fall within auditors' 'normal' reporting obligations to regulators.

Were auditors to be conferred with additional latitude, or responsibilities, to make public interest reports to the appropriate authorities, it is suggested that any such developments should to be accompanied by:

- clarity, i.e., with regard to the basis upon which public interest reports could/should be made and to whom such reports could/should be made;
- appropriate risk mitigating measures as alluded to above; and
- expanded Transparency Reporting requirements, specifically with reference to how affected firms ensure compliance with any public interest reporting obligations (i.e., equivalent to the reporting obligation currently required under Article 40(1)(d)) of the Directive *vis-a-vis* firms' internal quality control systems and the effectiveness thereof).

It should be noted that, as outlined under 'Context' above, auditors' communications with relevant financial institutions regarding those entities' business models and strategies and business and lending practices are currently under investigation by the Banking Commission. The comments provided above are, therefore, being provided without the benefit of the findings of that exercise.

Question 3

Do you believe that the general level of audit quality could be further enhanced?

Response

Taking a broad, high level, interpretation of the term 'audit quality' it could be argued that quality comprises of both:

- i. the standard of performance of audits; and
- ii. stakeholders' perceptions as to the usefulness/relevance of audit as currently formulated (which might include considerations such as scope as provided for by legislation and standards and the outputs of the process).

With reference to (i) above, whilst IAASA does not perform inspections of audit firms itself (but, rather, oversees the performance of such activity by professional bodies)¹⁹, it is clear that certain of those independent audit regulators that do perform inspections see scope for improvement within their review constituencies. The following extract from the press statement that issued following the most recent IFIAR plenary meeting is of relevance in that regard:

'Some IFIAR members presented their recently published reports. Examples of areas of inspection findings at the engagement level in these reports included:

- *concerns with the exercise of professional scepticism;*
- *the recognition and handling of fraud risk;*
- *the audit of impairments; and*

¹⁹ The Minister for Trade & Commerce has recently decided that the European Commission's Recommendation on external quality assurance of auditors of public interest entities should be implemented. It has further been decided that the Recommendation will be implemented in the form of the performance of direct inspections by IAASA. At the time of writing, IAASA has commenced the development of an implementation plan at the Minister's request.

- the provision of non-audit services and other threats to auditor independence.

At the firm level, examples of findings related to Engagement Quality Control Reviews, the firms' own inspection processes and the firms' incentive structures'.

The issues that arise in any consideration of (ii) above are dealt with in responses to certain of the other questions posed in the Paper.

Question 4

Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such purposes?

Response

General purpose financial statements, as prepared in accordance with IFRS, are historical in nature and are primarily designed to provide users with details of a reporting entity's:

- profit or loss for the period; and
- financial position as at the reporting date.

That said, reporting entities' directors are required to assess whether the entity with which they have been charged with the governance of is likely to continue in business for the foreseeable future for the purpose of determining whether it is appropriate to prepare the financial statements on a going concern basis.

Under ISA (UK and Ireland) 570²⁰, auditors are required to:

- obtain sufficient appropriate evidence about the appropriateness of the directors' use of the going concern assumption; and
- conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

ISA (UK and Ireland) 570 does, however, make clear that, as auditors cannot predict future events or conditions that might cause an entity to cease to continue as a going concern, the absence of reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

In addition, issuers are required, under the Transparency Directive, to provide details of the principal risks and uncertainties facing them over the coming months. Such disclosures do not, however, currently require to be opined upon by auditors.

In an Irish context, and as alluded to earlier, there would appear to be a view in certain quarters that audited financial statements (at least of systemically important entities) should provide a greater level of information regarding reporting entities' future financial health and prospects. That being the case, and looking at the issue in the broader European context in which the Paper is set, it would seem that if users wish to be provided with a greater level of information regarding reporting entities' future financial prospects:

- the nature of such additional information requirements should be communicated by investors and other users to (i) those charged with governance; and (ii) legislators and policy makers; and

²⁰ Paragraphs 6 and 7 refer

- to the extent practicable such information should, in the first instance, be provided by those charged with those entities' governance.

Depending upon the nature of any such additional information that investors and/or other users are desirous of receiving, the extent to which:

- such information might lend itself to being opined upon by auditors;
- the scope of statutory audit, as currently formulated, might require amendment or augmentation in order to facilitate the provision of additional assurance; and
- the provision of assurance thereon would be likely to be of added value to users,

could be assessed in consultation with key stakeholders.

Using the Irish banking crisis as a point of reference, users might, arguably, have benefited had those charged with financial institutions' governance been required to report publicly on some or all of the following and to submit – some or all of – their reporting in that regard to external scrutiny (for example, with a view to the provision of an independent opinion as to whether the directors' narrative is fair and reasonable or reasonable and balanced):

- the appropriateness and efficacy of those entities' governance arrangements, together with the basis for the directors' assertions and conclusions in that regard;
- the directors' assessment as to the sustainability of those entities' business models, together with the basis for the directors' assertions and conclusions in that regard;
- the appropriateness and efficacy of those entities' risk management arrangements, together with the basis for the directors' assertions and conclusions in that regard, with regard to, for example:
 - the processes and procedures for ensuring the quality and comprehensiveness of risk management material tabled before the Board and Board Committees;
 - the extent to which those charged with governance:
 - are satisfied that they understand the key risks being run by the business and the basis for their assertions and conclusions in that regard;
 - are satisfied as to the appropriateness of the measures taken to mitigate those risks and the basis for their assertions and conclusions in that regard;
 - monitor the effectiveness of those measures and respond to ineffectiveness as necessary;
- the appropriateness and efficacy of key internal control systems and processes (i.e. key to the business as opposed to key to the financial statements), together with the basis for the directors' assertions and conclusions in that regard;
- whether effective processes are in place to detect, and bring to the attention of those charged with governance, instances of control override, together with the basis for the directors' assertions and conclusions in that regard;
- whether effective processes are in place to detect and bring to the attention of (i) those charged with governance and (ii) the prudential regulator, instances of non-compliance with

prudential requirements and stipulations, together with the basis for the directors' assertions and conclusions in that regard;

- whether effective processes are in place to expeditiously remediate instances of non-compliance with prudential requirements and stipulations, together with the basis for the directors' assertions and conclusions in that regard;
- the role and mandate of Internal Audit, together with details of:
 - Internal Audit's work plan as approved by the Audit Committee;
 - the process for addressing Internal Audit's recommendations and the procedures that must be adopted in circumstances where non-acceptance of recommendations by management is proposed.

The nature of the foregoing issues, which as set out above have been formulated using the Irish banking crisis as a point of reference, would suggest that there is scope for statutory audit to make a greater contribution to promoting effective prudential management, governance and supervision of systemically important financial institutions. Of course, and as expressly stated in the Paper, any such contribution should not be allowed in any way to blur the respective responsibilities of those charged with governance, auditors and prudential regulators.

Clearly, in order to facilitate auditor reporting on some or all of the foregoing, the scope of statutory audit, as currently formulated, would require amendment and this would, *inter alia*, have potentially significant cost implications for issuers.

Question 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?

Response

Yes, the provision of additional detail regarding the audit methodology employed should, if appropriately formulated and communicated, serve to clarify the role of audit and, by extension, narrow the expectation gap to some extent.

It is suggested that users would further benefit were auditors to provide a greater level of detail than is currently the case regarding, for example:

- aspects of the audit to which the exercise of professional judgement was central; and
- the considerations that were had regard to in arriving at key audit judgements.

Question 6

Should "professional scepticism" be reinforced? How could this be achieved?

Response

As referred to in the response to question 3 above, a number of IFIAR members that perform direct inspections have expressed concerns regarding auditors' exercise of professional scepticism. That being the case, there would appear to be a need to further reinforce auditors' approach towards, and application of, professional scepticism.

It is suggested that those best placed to effect improvements in that regard include:

- audit firms' national, regional and global leadership teams;

- those charged with governance and, in particular, Audit Committees;
- investors through a greater level of dialogue with Audit Committees and audit firms; and
- audit oversight authorities through the performance of robust and independent quality assurance reviews and the publication of the resultant reports.

In addition to the foregoing, IAASA is aware that this matter has been considered in detail elsewhere. Accordingly, the Commission's attention is drawn, in particular, to the UK Financial Reporting Council's ('FRC') recent Discussion Paper on the topic of auditor scepticism²¹.

Whilst acknowledging that the following are not measures of professional scepticism, there may be merit, in stakeholders' interest, in requiring those audit firms engaged in the audit of public interest entities' financial statements to provide additional information such as that set out below in their annual Transparency Reports:

- the number of audits completed in the year;
- the number of unqualified audit opinions issued;
- the number of adverse and qualified opinions issued;
- the number of statutory, or other, reports made to criminal and civil authorities during the year.

It is suggested that additional information such as that set out above would further serve to assist:

- those charged with governance in their deliberations as to which audit firm should be recommended for appointment; and
- shareholders in arriving at their decisions in that regard.

Question 7

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

Response

The primary purpose of an audit is to enable the auditor to form an opinion as to whether a set of financial statements give a true and fair view of the reporting entity's financial performance and position respectively. Accordingly, upon the completion of the audit, the auditor is required to form an opinion as to whether the financial statements:

- give a true and fair view; or
- do not give a true and fair view.

Given that an adverse audit opinion indicates that the auditor considers the financial statements to be misstated, both materially and pervasively, it is unsurprising that such opinions are viewed negatively, particularly in the context of entities whose securities have been admitted to trading on regulated markets.

²¹<http://www.frc.org.uk/images/uploaded/documents/Discussion%20paper%20Auditor%20Scepticism%20-%20raising%20the%20bar21.pdf>

ISA (UK and Ireland) 705 recognises that circumstances may arise where, notwithstanding that the financial statements contain a material misstatement, that misstatement is not pervasive. In those circumstances the auditor has latitude to provide a qualified opinion. Where a qualified opinion issues, the auditor will set out the basis for that opinion, and, in particular, the nature of the issue(s) considered to constitute the non-pervasive material misstatement.

Whilst a qualified opinion constitutes a lesser degree of criticism of a set of financial statements and, by extension, of those who prepared and approved same, it will nevertheless, similarly, be viewed negatively, particularly in the context of entities whose securities have been admitted to trading on regulated markets.

For the foregoing reasons, there is a perception that auditors:

- come under, and are at risk of succumbing to, pressure from reporting entities' management not to issue adverse/qualified opinions where same are considered to be appropriate; and
- are reluctant to issue adverse/qualified opinions as to do so might risk losing the client.

Irrespective of whether these perceptions have any basis in fact, they exist and it is suggested, therefore, that they need to be addressed as part of any measures aimed at restoring confidence in the audit profession. IAASA is not convinced, however, that the risks referred to above are best addressed by seeking to reduce the negative perceptions attaching to adverse and qualified audit opinions – after all, in the context of issuers, adverse/qualified opinions are a significant risk indicator. Rather, IAASA tends towards the view that such risks might more appropriately be addressed, *inter alia*, through:

- enhanced transparency on the part of audit firms regarding their independence practices – such as will be facilitated by the publication of Transparency Reports;
- enhanced transparency on the part of audit firms regarding their audit methodologies (the response to question 5 above refers);
- further supporting auditor independence;
- the performance of frequent, robust and independent external quality assurance inspections; and
- the public reporting of inspection findings.

Question 8

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

Response

Please see the responses above to questions 2, 4 and 5.

Question 9

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

Response

Given that IAASA does not currently perform quality assurance inspections, IAASA is not particularly well placed to offer observations as to whether there is adequate and regular dialogue between external auditors, internal auditors and Audit Committees.

Question 10

Do you think auditors should play a role in ensuring the reliability of the information companies report in the field of Corporate Social Responsibility ('CSR')?

Response

Whilst there may be some scope for auditor reporting in this area, IAASA tends towards the view that, for the moment, the primary emphasis should be on seeking to identify ways by which financial reporting and audit can:

- better meet the needs and expectations of users; and
- enable users to make better, more informed, decisions.

Any move towards requiring auditors to report on CSR matters would also, of course, have to have regard to auditors' skills and competencies and the inherent limitations thereon.

Question 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?

Response

IAASA would suggest that, in large measure, the answer to this question will be driven by what auditors are required to report on, i.e., if auditors are merely reporting that, for example, quarterly or half-yearly financial reports give a true and fair view, the benefit of more frequent reporting would, it is suggested, be questionable. In contrast, were auditors required to report more frequently on matters such as those referred to in the response to question 4 above, it is possible that more frequent reporting would be of enhanced benefit to users.

With regard to the gap between the reporting date and the date of issuance of the audit report, it is suggested that, whilst there may be ways of shortening this period to some extent, ensuring that sufficient time has been allotted to ensure that the audit has been performed to the requisite standard should be of paramount importance.

Question 12

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

Response

In an Irish context and as detailed earlier in this response, complex financial products did not play a significant role in the banking crisis. Rather, the most significant financial reporting issue that has arisen has been that of the reporting of loan loss impairments.

With reference to the suggestion in the Paper that consideration might be given to 'going back to basics', whilst there may be a case for increasing the level of assurance provided by statutory audit and, by extension, increasing the level of substantive testing to be undertaken, IAASA would question the logic of abandoning the testing of, and, where considered appropriate, reliance on, internal control as a contributor to the overall level of assurance derived from the audit.

Clearly, any move away from the extant model of risk based auditing to a more substantive testing based model would be likely to give rise to considerable cost implications.

Question 13

What are your views on the introduction of ISAs in the European Union?

Response

ISAs are already in use in Ireland, having been implemented in the form of ISAs (UK and Ireland) as promulgated by the UK's Auditing Practices Board ('APB'). In Ireland, ISAs (UK and Ireland) derive their authority from the Recognised Accountancy Bodies' constitutions, which require IAASA's approval. Accordingly, IAASA supports the introduction of ISAs in the EU.

Question 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 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)?

Response

IAASA is of the view that what is of most importance in this context is that whatever approach is adopted should serve to ensure that national standard setters and/or regulators are not precluded from:

- stipulating additional requirements as considered necessary or otherwise appropriate, e.g., to address jurisdiction specific considerations; and
- issuing supplementary guidance to auditors where this is considered appropriate.

Question 15

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

Response

IAASA's understanding is that the IAASB considers ISAs to be adaptable to audited entities' individual circumstances, e.g., size, complexity etc. On that basis, IAASA would not consider the further adaptation of ISAs to be necessary.

Question 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?

Response

Notwithstanding that auditors' reports are addressed to companies' members, audit firms are, in effect:

- appointed by those charged with governance/management; and
- remunerated by those charged with governance/management.

This model gives rise to the potential for conflicts of interest to arise. In an effort to address this issue, the Directive²², provides that, in the case of public interest entities, proposals for the appointment of the statutory auditor shall be based on a recommendation of the Audit Committee.

²² Article 41(3)

Whilst this stipulation provides some comfort to members, as mooted in the Paper, there may be an argument, e.g., in the case of systemically important financial institutions, for the statutory auditor to be approved as being suitable for appointment by an independent third party (e.g., the prudential regulator²³). More broadly, it would seem that:

- those charged with governance could do more to actively encourage investors to participate in decisions regarding auditor appointment; and
- investors could do more in terms of seeking to actively participate in such decisions.

Question 17

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

Response

It is suggested that, on balance, the default position should remain that the members of the company appoint the auditor as appointment by an external party would serve to disenfranchise shareholders. However, and as indicated above, there may be merit in an arrangement whereby, in the case of systemically important entities, auditors must be approved in advance as being suitable for appointment.

It is conceivable, however, that circumstances might arise from time to time in which such an approach was considered to be appropriate (e.g. appointment by a prudential regulator) – that being the case, it would seem not unreasonable that prudential regulators would have some degree of latitude, within specified parameters, to appoint auditors where considered necessary or otherwise appropriate.

Question 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?

Response

Whilst conscious of the arguments that the mandatory rotation of auditors:

- i. could have adverse consequences for audit quality (e.g., through giving rise to a loss of knowledge etc.); and
- ii. could give rise to unintended consequences,

IAASA is of the view that there is merit to the argument that, in the interests of supporting auditor independence and public confidence therein, consideration should be given to limiting firms' uninterrupted tenure as auditors to public interest entities. With reference to (i) above, as elaborated upon further in the response to question 28 below, IAASA considers that joint audit could play a role in mitigating such risks.

As acknowledged in the Paper, any such limitation would also have to ensure that the issue of partners and other key audit personnel changing firms was adequately addressed.

²³ Logic would suggest that it would be inappropriate for an audit regulator to have a role in this regard as to do so would, similarly, give rise to inherent conflicts of interest.

Question 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?

Response

The provision of non audit services by audit firms in Ireland is governed by the:

- i. Statutory Audit Directive Regulations, which transposed the Directive; and
- ii. the APB's Ethical Standards ('ES'), which derive their authority from the Recognised Accountancy Bodies' constitutions, which require IAASA's approval (the APB is the independent standard setter for auditing and ethical standards in the UK and Ireland).

Regulation 41 of the Statutory Audit Directive Regulations transposes Article 22 of the Directive by stipulating that statutory auditors and audit firms are subject to the requirements of Article 22. Article 22 of the Directive sets out the independence and objectivity requirements for auditors.

Regulation 71 elaborates on this principle by providing that the auditor shall not carry out a statutory audit if, *inter alia*, the auditor (or a network to which it belongs) has a relationship with the audited entity (such a relationship including the provision of non audit services) if an objective, reasonable and informed third party would conclude that, by virtue of that relationship, the auditor's independence is compromised. Regulation 71(3) provides that, if the auditor's independence is affected by threats such as self review, self interest, advocacy, familiarity or trust or intimidation, the auditor shall apply safeguards in order to mitigate such threats (unless the application of safeguards would not serve to sufficiently mitigate the threat, in which case the auditor should not carry out the audit).

The APB's ES5 '*Non-audit services provided to audited entities*' similarly adopts a threats and safeguards approach although it does, in certain instances, prohibit the provision of specified non audit services²⁴.

In October 2009, and in response to a recommendation from the UK Parliament's Treasury Select Committee, the APB initiated a consultation exercise with a view to assessing the ongoing appropriateness of its chosen approach towards the provision of non audit services. The APB received a total of 150 responses. Per the APB's subsequently published feedback paper²⁵, the message from commentators (irrespective of the constituency involved) was overwhelmingly that there should:

- not be an outright prohibition; and
- be no major change to the conceptual approach taken to the provision of non-audit services by auditors to the entities that they audit.

Based on its analysis of the responses received, the APB concluded that:

- a blanket prohibition of non-audit services would not be proportionate;

²⁴ i.e., internal audit services in certain circumstances, the design, provision or implementation of IT services in certain circumstances, valuation services in certain circumstances, actuarial valuation services in certain circumstances, the promotion of tax structures/products and the provision of tax services in certain circumstances, litigation support services in certain circumstances, legal services in certain circumstances, recruitment services in certain circumstances, remuneration related services in certain circumstances, corporate finance services in certain circumstances, transaction related services in certain circumstances; and the provision of accounting services in certain circumstances.

²⁵ <http://www.frc.org.uk/images/uploaded/documents/Consultation%20provision%20of%20non-audit%20services%20by%20auditors1.pdf>

- there are a number of specific services (audit related services) in relation to which the APB believes that most shareholders would not consider it controversial for the auditor to undertake the work; and
- the procuring of non audit services from a reporting entity's auditors is primarily one of corporate governance and that, in that context, certain additional disclosures, if implemented effectively, would result in greater transparency, especially of companies' policies on non audit services, the nature of the non-audit services provided by auditors, the extent and nature of safeguards applied and the reasons why it is considered appropriate for the auditor, rather than another party, to provide these services. The APB further concluded that the aforementioned additional disclosures should provide investors with the tools they need to be more effective in their challenge of management and those charged with governance and thereby stimulate a dialogue between companies and the investment community which could result in a mutual understanding of what are considered to be acceptable types of non audit services to be provided by the auditor and, where considered relevant, what level of non-audit services is generally appropriate.

Whilst IAASA is supportive of the APB's position and considers same to be an appropriate model for consideration in an EU wide context, IAASA nevertheless anticipates that there will be considerable pressure for the introduction of an outright ban on the provision of non audit services in the interests of restoring public confidence notwithstanding the counterarguments that such a ban might be expected to have implications in terms of:

- audit quality, i.e., in the context of auditors' knowledge of clients' business; and
- the cost of audit.

Question 20

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

Response

Yes. In Ireland this is an issue that is already regulated, i.e., by the APB's ES 4 '*Fees, remuneration and evaluation policies, litigation, gifts and hospitality*'. Specifically, ES provides that:

- where it is expected that the total fees for both audit and non audit services receivable from a non-listed entity and its subsidiaries audited by the audit firm will regularly exceed 15% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm shall not act as auditor of that entity and shall either resign as auditor or not stand for reappointment, as appropriate; and
- where it is expected that the total fees for both audit and non audit services receivable from a listed entity and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or, where profits are not shared on a firm-wide basis, of the part of the firm by reference to which the audit engagement partner's profit share is calculated, the firm shall not act as auditor of that entity and shall either resign as auditor or not stand for reappointment, as appropriate.

ES 4 further provides that:

- where it is expected that the total fees for both audit and non audit services receivable from a non-listed entity and its subsidiaries audited by the audit firm will regularly exceed 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 15%, the audit engagement partner shall disclose that expectation to the ethics partner and to those charged

with governance of the audited entity and the firm shall arrange an external independent quality control review of the audit engagement to be undertaken before the auditor's report is finalised²⁶;

- where it is expected that the total fees for both audit and non audit services receivable from a listed entity and its subsidiaries audited by the audit firm will regularly exceed 5% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated, but will not regularly exceed 10%, the audit engagement partner shall disclose that expectation to the ethics partner and to those charged with governance of the audited entity and consider whether appropriate safeguards need to be applied to eliminate or reduce to an acceptable level the threat to the auditor's objectivity and independence.

IAASA considers the APB's approach to this subject to be appropriate and to merit consideration in a wider EU context.

Question 21

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

Response

Context

In Ireland, until recently (i.e., up until the transposition of the Directive), audit firms were not permitted to incorporate. Accordingly, such firms:

- have historically been constituted as partnerships in which the partners have unlimited liability; and
- have not, therefore, been required to publish financial information.

In the short period since the Directive was transposed, IAASA is not aware of any significant take up on the part of audit firms of the newly introduced option to incorporate. It remains to be seen at this time as to whether there will be a significant level of take up in this regard.

Given that the Directive was only transposed relatively recently, Irish audit firms have not at this time published their first Transparency Reports. Accordingly, there is relatively little financial information in the public domain regarding audit firms' financial performance and position respectively *vis-a-vis* the position in certain other Member States (e.g., Member States where audit firms typically operate through bodies corporate).

Publication of audited financial statements

In Ireland the 'Big 4'²⁷ audit firms dominate the listed entity audit market (the 'Big 4' firms act as auditors to 94% of those equity issuers coming within IAASA's remit under the Transparency Regulations). Given:

- that this is a statistic that is replicated elsewhere within the European Union;
- the fact that there are only 4 such firms/networks;
- the consequential potential for market disruption were one of those firms/networks to fail or otherwise exit the audit market,

²⁶ The APB's ES 'Provisions Available For Small Entities' (Revised) provides that the requirement for an independent external quality control review does not apply when an audit firm is auditing the financial statements of a small entity.

²⁷ Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers

as suggested in section 5 of the Paper, there is an argument for concluding that these firms are of systemic importance.

That being the case, IAASA is of the view that there is merit in the argument that, from a public interest perspective, there should be a high degree of transparency around these firms'/networks' financial positions and stability respectively. This argument is all the stronger in circumstances where auditors' liability is capped, or limited by some other means, by the State.

Question 22

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

Response

IAASA has reviewed the Audit Firm Governance Code ('the Code'), as recently published by the FRC and the ICAEW²⁸, and has, in particular, noted the intended benefits of the Code, which are stated as being as follows:

'The Working Group has drafted the Code to serve the interests of shareholders in listed companies to whom auditors address their reports. The Code supports firms in their objectives of performing high quality work that gives confidence to shareholders. It should also benefit capital markets by enhancing choice and helping to reduce the risk of a firm exiting the market for large audits because it has lost public trust. Exit from the market would not only signal the loss of a firm's substantial investment in its reputation, but would also have adverse effects on the functioning of markets and on the availability of choice for users of audit services. Our aim is that the Code should play four additional roles:

- *enhance the stature of firms as highly visible exemplars of best practice governance;*
- *enrich firms' transparency reports;*
- *encourage changes in governance which improve the way that firms are run; and*
- *strengthen the regulatory regime by achieving transparent and effective governance without disproportionate regulation'.*

Having reviewed the Code, IAASA has concluded that implementation in Ireland would be likely, *inter alia*, to:

- enhance the larger audit firms' governance arrangements;
- serve to enhance those firms' dialogue with shareholders and other key stakeholders;
- present those firms with an opportunity to publicly communicate their:
 - core values;
 - commitment to the public interest;
 - commitment to complying with professional standards and legal and regulatory requirements; and
 - commitment to professionalism,

²⁸ Institute of Chartered Accountants in England & Wales

thereby contributing to a restoration of public confidence in the profession.

Consequently, IAASA has, in recent months, initiated a dialogue with relevant professional bodies and firms with a view to:

- obtaining their analysis of the Code's provisions;
- understanding any difficulties they would envisage with implementation of the Code in Ireland;
- understanding any other reservations that they might have about implementation and the basis for any such reservations; and
- understanding any benefits they see as being likely to derive from the Code.

At this time, IAASA's dialogue with the relevant parties is ongoing.

Question 23

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

Response

Yes, subject to the use of any such alternative structures being conditional upon adherence to specified requirements designed to safeguard auditors' independence.

Question 24

Do you support the suggestions regarding group auditors? Do you have any further ideas on the matter?

Response

Yes, IAASA supports the suggestions regarding group auditors.

Question 25

Which measures should be envisaged to improve further the integration and co-operation of audit firm supervision at EU level?

Response

IAASA shares the view that the current mismatch between global audit networks and local supervision needs to be addressed. However, without a more detailed analysis, *inter alia*, of:

- what is envisaged by the term 'a new European Supervisory Authority';
- the merits and demerits of a Level 3 Committee and a European Supervisory Authority, as envisaged, respectively;
- the budgetary implications of each,

it is difficult to form a view as to which, if either, might be a more appropriate response.

The Directive has only recently been transposed in Ireland and, as a consequence, IAASA has had no practical experience at this time of whether the provisions set out therein in respect of Member States' co-operation with each other are likely to operate effectively.

Question 26

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

Response

As it is neither a prudential nor securities regulator, IAASA is not in a position to comment on the effectiveness of auditors' communications with such regulatory bodies.

Clearly however, and as alluded to in response to question 4 above, there is scope for considerable mutual benefit from such communications. That being the case, IAASA would agree that any weaknesses or deficiencies that are currently perceived to exist in that regard, including any impediments arising as a result of relevant parties' duties of confidentiality and/or professional secrecy, should be addressed.

Given that, as set out in the covering letter, the Banking Commission has been charged with, *inter alia*, examining certain aspects of auditors' performance, IAASA anticipates that the Commission's report is likely to include certain observations and recommendations in this regard.

Question 27

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

Response

IAASA's view in this regard is that there is a broad consensus at this time that the current configuration of the audit market for listed entities presents certain systemic risks. As set out in the response to question 21 above, in Ireland the 'Big 4' audit firms act as auditors to 94% of those equity issuers coming within IAASA's remit under the Transparency Regulations.

Question 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 dynamising the audit market and allowing smaller and medium-sized firms to participate more substantially in the segment of larger audits?

Response

Whilst measures aimed at increasing 'mid tier' firms' participation at the top end of the audit market might be expected to have a positive impact in terms of increasing choice and serving to mitigate some of the systemic risks associated with the current dominance of the 'Big 4' firms, IAASA is not convinced that mandating the formation of audit consortia or the appointment of joint auditors is an appropriate response. Rather, IAASA would tend towards the view that it is the responsibility of those charged with governance, Audit Committees and investors respectively to ensure that the audit arrangements put in place are those likely to best serve those to whom the auditor reports.

That said, where auditors are rotating off an engagement after lengthy periods, there might be merit in the incoming and outgoing auditors acting as joint auditors over a transitional period in advance of the incoming auditor becoming the sole auditor. Such an arrangement would, albeit at a greater cost to the issuer, serve to mitigate any risks to audit quality that might otherwise arise by virtue of the incoming auditor's relative lack of knowledge of the client's business in the early years of the engagement.

Question 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?

Response

IAASA would be supportive of the concept of regular tendering.

As indicated in the response to question 18 above, IAASA is also of the view that there is merit in considering whether firms' uninterrupted tenure as auditors should be limited. Notwithstanding the arguments against mandatory rotation, it is clear that firms' lengthy, uninterrupted tenure as auditors gives rise to problems of perception and, as a consequence, militates against confidence in the profession. Whilst difficult to specify a particular maximum tenure that might apply, IAASA considers that uninterrupted tenures stretching beyond the order of eight to ten years are likely to give rise to the perception issues referred to above.

Question 30

How should the 'Big 4' bias be addressed?

Response

Given that IAASA does not perform direct inspections, it is not in a position to offer first hand observations as to the extent to which the additional 'comfort' referred to in the Paper is attributable to perception or merit respectively. It is difficult, therefore, to comment further on this matter.

Question 31

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

Response

IAASA agrees that the formulation of appropriate contingency arrangements would be a prudent step for the Commission to seek to take in conjunction with Member States and other interested parties. Arrangements such as those referred to in the Paper could, as suggested therein, contribute to the expeditious resolution of failure-related issues and the minimisation of associated market disruption. Whether, however, such arrangements would serve to mitigate systemic risks and/or the risk of firm failure is, it is suggested, less clear.

Question 32

Is the broader rationale for consolidation of large firms over the past two decades (i.e. global offer, synergies) still valid? In which circumstances could a reversal be envisaged?

Response

By virtue of not currently having a direct relationship with the larger audit firms, IAASA does not consider itself to have the level of insight into those firms' operations necessary to offer a view on this question at this time.

Question 33

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

Response

The Directive has implemented a system of recognition of the qualifications of statutory auditors that have been approved in other Member States²⁹. It would seem appropriate, therefore, to first assess the success of this system before additional changes are considered.

Question 34

Do you agree with 'maximum harmonisation' combined with a single European passport for auditors and audit firms? Do you believe this should apply for smaller firms?

Response

If it is determined that the creation of a European Supervisory Authority is appropriate, it would then seem logical to have a single European passport for auditors and audit firms. Otherwise, the new system of recognition of Member State statutory auditors, as alluded to in the response to question 33 above, would seem sufficient.

Question 35

Would you favour a lower level of service than an audit, a so call '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?

Response

IAASA would not favour the introduction of terms such as 'limited audit', not least given that there is already a significant gap between what an audit is and stakeholders' understanding in that regard. To introduce terms such as that referred to above would, it is suggested, merely serve to further confuse stakeholders.

If the Commission wishes to free SMEs of the regulatory burden of statutory audit, it is suggested that this should most appropriately be effected through further increasing the scope for audit exemption.

There would, it is suggested, be benefit in seeking to ensure that, where audit exempt entities wish to procure alternative forms of assurance in respect of their financial statements (i.e., services providing a lesser level of assurance that is provided by statutory audit), that the nature of such assurance would, to the extent practicable, be commonly understood across the EU.

Question 36

Should there be a safe harbour regarding any potential future prohibition of non audit services when servicing SME clients?

Response

IAASA would draw attention to the arrangements that currently prevail in this regard in Ireland, i.e., the APB's ES 'Provisions Available For Small Entities' (Revised)³⁰.

²⁹ Article 14

³⁰ <http://www.frc.org.uk/images/uploaded/documents/ES%20-%20PASE%20-%20v5%20clean.pdf>

Question 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 would be done in practice?

Response

Please refer to the response to question 35 above.

Question 38

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

Response

Whilst still in its early stages of development, IAASA considers that IFIAR provides a sound platform on which co-operation between:

- international audit regulators and their counterparts;
- international audit regulators, audit firms and investors; and
- international audit regulators and other interested parties, including the Commission,

can continue to develop.