American Institute of CPAs
1211 Avenue of the Americas
New York, NY 10036-8775

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Michel Barnier
European Commissioner for Internal Market and Services
European Commission
BERL 10/034
B - 1049 Brussels
Belgium

Via email: markt-greenpaper-audit@ec.europa.eu

Re: European Commission Green Paper on *Audit Policy: Lessons from the Crisis*

Dear Commissioner Barnier:

The American Institute of Certified Public Accountants (AICPA) is the professional association of CPAs with 369,000 members worldwide in business and industry, public practice, government, education, student affiliates and international associates. As part of our role in the United States, we set ethical and independence standards for the CPA profession and U.S. auditing standards for audits of private companies, nonprofit organizations, federal, state and local governments.

We thank you for the opportunity to comment on the European Commission's (Commission) green paper on *Audit Policy: Lessons from the Crisis* (Green Paper). Our comments address the key issues and topics set forth in the Green Paper and where possible, respond to the specific questions posed by the Commission.

General Comments

The AICPA commends the Commission for its efforts to open a dialogue and seek comment from a broad range of stakeholders on various measures aimed at enhancing financial stability and confidence in the global capital markets. We support the Commission's initiative to address the role of the auditor, the governance and the independence of audit firms, the supervision of auditors, and other issues raised in the Green Paper. However, we believe any resulting recommendations for improvements should be subject to robust cost-benefits analyses and impact assessments. While we agree that the audit profession plays an important role in maintaining trust and confidence in the capital markets, the issues raised in the Green Paper imply that the audit profession may have played a significant role in the recent global financial crisis. We are unaware of any evidence to support that the audit profession somehow contributed to the financial crisis but would agree that there may be lessons learned that could possibly improve the role and quality of the audit.

T: 212.596.6200 | F: 212.596.6213 | aicpa.org

Many of the issues raised in the Green Paper have already been considered by other regulatory and standard-setting bodies around the world and extensive research and debate has taken place on these issues. For example, in the U.S. some of these issues were addressed under the Sarbanes-Oxley Act of 2002 which resulted in a number of reforms to enhance corporate governance, enhance financial disclosure, combat corporate and accounting fraud and the creation of the Public Company Accounting Oversight Board (PCAOB) to oversee the activities of auditors of listed entities. The U.S. Treasury's Advisory Committee on the Auditing Profession also examined the condition and future of the auditing profession and in October 2008, released its final report and recommendations to enhance the sustainability of the public company auditing profession.[1] We would therefore encourage the Commission to closely consider the extensive discussions, testimony and research that already exists on these issues. We also urge the Commission to be mindful that many of the issues should be considered in the broader context of the responsibilities of regulators, audit committees and boards of directors and the roles they play with respect to high quality audits. In addition, the Commission should take into account the global marketplace in which audits are conducted and recognize that any measures implemented in the European Union (EU) will very likely impact audit practice and regulatory regimes outside the EU. Finally, any recommendations must take into account the current legal liability environment that auditors face around the world and the need for further reform if certain of these proposals are implemented.

Specific Comments

Role of the Auditor (Qs. 3, 5, 6, 8, 10, 11, 13, 15)

Audit quality, like most processes, should always be subjected to constant and continuous improvements. Part of that process should always consider users' needs of the audit and their willingness to absorb the added costs for incremental increases in quality. In other words, there must be a balance between the additional costs associated with audit enhancements and the resulting benefits to users of the audit.

The IAASB has spent several years in rewriting its standards to improve their clarity. At this point, they represent high quality auditing standards that are used around the world. We acknowledge that the audit process could be better communicated to users and we support the IAASB's research efforts to explore the perceptions of users of the audit report and to find ways to better communicate the scope and results of the audit.

We also believe professional skepticism is a critical skill for auditors and would support additional academic preparation and continuing professional training programs on this issue. We suggest that further research be undertaken to assess how professional skepticism is implemented. In addition, more research should be undertaken to explore the behavioral elements that may compromise professional skepticism; for example, auditor behavior which is influenced by individual biases and paradigms.

Applying professional skepticism appropriately is important in the assessment of fraud risk, including the risk of management override of controls, and in the design of audit testing to

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[1] http://www.ustreas.gov/offices/domestic-finance/acap/docs/final-report.pdf

respond to identified risks. However, we would like to point out that preventing and detecting fraudulent financial reporting is not only the auditor's responsibility. Maintaining a high level of objectivity is also critical for others having governance and oversight over the financial reporting process (e.g., audit committees, boards of directors, management and internal auditors). The Commission may therefore wish to consider the roles and responsibilities of those charged with corporate governance and oversight responsibilities and what they can do to better manage the business risk of financial reporting fraud. That would include consideration of the financial reporting competencies needed by those individuals with governance and oversight responsibilities.

Additionally, auditors can be a valuable resource for boards of directors and audit committees by providing insights on the company's ethical culture, the effectiveness of its internal control, and its exposure to management override, including information on leading practices in similar companies. The external auditors can also advise the board and audit committee on appropriate questions to ask management.

The Commission has asked whether additional information should be provided to external stakeholders (Q. 8). Our understanding, based on the corresponding section of the Green Paper, is that this question focuses specifically on "what sort of information should be provided to stakeholders by the auditor as part of its opinion and findings." Our response is limited specifically to the suggestion on page 8 of the Green Paper that "Another potential consideration may be the extent to which information of public interest that is available to auditors should be communicated to the public. Examples of such information may be the company's exposure to future risks or events, the risks to intellectual property, the extent to which intangible assets would be adversely affected, etc." While we agree that these examples represent relevant stakeholder communications, and we have for many years advocated *for companies* to make such disclosures through the work of various AICPA Committees and most recently the Enhanced Business Reporting Consortium[2] and the World Intellectual Capital Initiative,[3] we feel strongly that it is the role and responsibility of the company, not the auditor, to communicate such information to company stakeholders.

We also believe that auditors should continue to play a role in ensuring the reliability of the information companies are reporting in the field of Corporate Social and Environmental Responsibility (CSR). Auditors can add value to their clients by providing services related to the development of sustainable business strategies, sustainability accounting and reporting, and assurance. CSR represents an important area of corporate communications, and just as auditors perform services related to the financial statements, so should be the case for CSR and other key disclosures that might be made under an integrated reporting framework such as those being addressed by the International Integrated Reporting Committee and the World Intellectual Capital Initiative (both of which go beyond CSR to cover disclosures related to financial performance, environmental issues, social responsibility, governance, strategy, risk, intangibles, KPIs, and other non-financial measures). Current guidance in this area includes AICPA SOP 03-

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[2] http://www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/RESOURCES/EBR/Pages/EnhancedBusinessReportingConsortium.aspx
[3] http://www.wici-global.com/

2, *Attest Engagements on Greenhouse Gas Emissions Information*, developed by the Joint Task Force of the AICPA and CICA on Sustainability Reporting, which provides guidance for the application of assurance standard AT101 to greenhouse gas information. In February 2010, the AICPA also provided comments on the IAASB Consultation Paper: *Assurance on a Greenhouse Gas Statement*. A working group has been established under the AICPA Auditing Standards Board (ASB) to consider the need for specific guidance for providing assurance on sustainability reports, and the AICPA Assurance Services Executive Committee (ASEC) is working on the development of information integrity principles and criteria that could further facilitate the provision of assurance on non-financial information such as CSR disclosures. While the auditor can play a significant role in the area of CSR, we believe the auditor's involvement from an assurance standpoint should be market driven and not based on regulatory mandates.

We also support the efforts of the International Integrated Reporting Committee (IIRC), which was launched in August 2010 to create a globally accepted framework for accounting for sustainability as well as other non-financial factors. We suggest the Commission stand ready to act on IIRC recommendations as their work moves forward in 2011.

Finally, the AICPA supports the adoption of ISAs in the EU. We do not, however, believe they require further adaptation to meet the needs of SMEs and SMPs as the ISAs are designed to be applicable to the audits of entities of all sizes. The ISAs are already scalable depending on the size of the entity being audited (i.e., the amount of audit work required will be in proportion to the size of the company being audited.). In addition, the IAASB staff has also issued a document entitled "*Applying ISAs proportionately in the audits of SMEs*" and the IFAC Small and Medium Practices Committee issued the "*Guide to using ISAs in the audit of SMEs*" which provides comprehensive guidance to small and medium-sized practitioners with respect to the application of ISAs.

Governance and Independence of Audit Firms

Auditor Independence

The Green Paper discusses certain measures that may further enhance the independence of auditors. We believe many of these measures (e.g., prohibition on non-audit services, appointment of the auditor by third party, mandatory firm rotation) are unnecessary and the existing safeguards and prohibitions contained in the IESBA *Code of Ethics for Professional Accountants* are sufficient to ensure auditor independence. Furthermore, we believe some of these measures may actually undermine audit quality.

Appointment and remuneration of auditors (Qs. 16, 17) – We recognize that a self-interest threat may be created when the auditor is appointed and remunerated by the audited entity. However, we believe that the threat is sufficiently mitigated by various safeguards implemented by the profession, regulation and legislation as well as specific safeguards implemented in the work environment (see safeguards described in IESBA Code). For example, we acknowledge that a self-interest threat may be created when fees from an audit client represent a significant amount of the firm's revenues. As discussed in the IESBA Code, possible safeguards to mitigate the threat include having a pre- or post-issuance review of the audit by a professional accountant

outside the firm or regular independent external quality reviews of the audit engagement. For public interest entities, a pre- or post-issuance review of the engagement is mandated when fees exceed 15% of the firm's revenues. We believe the IESBA Code provides sufficient safeguards to mitigate the threat to independence under such circumstances.

Appointment of the auditor is based on a number of factors including industry expertise, staffing resources, and geographic area. We strongly believe audit committees and shareholders are in the best position to determine the appropriate firm to perform the company's audit. Any appointment by a third party would undermine the responsibilities and duties of audit committees and shareholders, who know their business best. We would support strengthening the role and responsibilities of the audit committee and the development of tools to assist it in evaluating the selection of the auditor. In addition, the Commission may wish to consider a requirement for listed entities to have a professionally qualified accountant to serve as the Chief Financial Officer.

Audit firm rotation – (Qs. 18, 29) There has been a significant amount of research performed (as described below) that indicates that mandatory audit firm rotation increases the propensity for fraud and does not promote audit quality. We believe the threats and safeguards approach discussed in the IESBA Code related to partner rotation is appropriate and sufficiently safeguards against the familiarity threat associated with using the same senior staff on an audit engagement for an extended period of time. For public interest entities, the IESBA Code includes a requirement that prohibits an individual from being a key audit partner for more than seven years; after such time, the individual is prohibited from being a member of the engagement team or a key audit partner for the client for two years. This adequately safeguards independence and there is no need to extend rotation requirements to the audit firm.

With regard to research, we offer the following examples of studies addressing mandatory audit firm rotation:

> COSO study - The most recent COSO study (*Fraudulent Financial Reporting: 1998-2007)* indicates that 26 percent of the fraud firms changed auditors between the last clean financial statements and the last fraudulent financial statements, whereas only 12 percent of no-fraud firms switched auditors during that same time. Sixty percent of the fraud firms that changed auditors did so during the fraud period, while the remaining 40 percent changed in the fiscal period just before the fraud began. (Fraud companies are twice as likely to change auditors as no-fraud firms between the last clean financial statements and the last fraudulent financial statements.)[4]
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> The International Chamber of Commerce (ICC) 2005 Policy Statement entitled, "*The Adverse Effects of Compulsory Audit Firm Rotation.*" The ICC concluded that "compulsory rotation of audit firms is the wrong solution for correcting real or perceived weaknesses in auditor independence and that compulsory rotation would have several adverse consequences, including negative effects on audit quality." It urged governments and regulatory authorities to reject compulsory rotation of audit firms and to support and

[4] http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf

implement more effective alternatives for reinforcing auditor independence that will not damage audit quality.[5]

U.S. Government Accountability Office (GAO) GAO November 2003 report, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation* - GAO reported that, "[M]andatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality, considering the costs of changing the auditor of record and the loss of auditor knowledge that is not carried forward to the new auditor."[6]

AICPA SEC Practice Section 1992 *Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies* - A study conducted by the SEC Practice Section Executive Committee of the AICPA concluded that mandatory audit firm rotation would not enhance audit quality or strengthen investor confidence in the objectivity of audits; to the contrary, rotation would be very costly and counterproductive to the advancement of the public interest. [7]

Studies performed on mandatory audit firm rotation consistently show that such a measure is not a desirable approach and can result in significant costs and inefficiencies for companies and their shareholders. Based on these studies, we do not see a basis for extending rotation requirements to audit firms and believe existing safeguards and restrictions sufficiently safeguard auditor independence.

Prohibition on non-audit services (Q. 19) – We recognize that certain non-audit services may result in threats to independence that cannot be mitigated (e.g., taking on management responsibilities) but many non-audit services do not impose a significant threat provided appropriate safeguards are implemented. The IESBA recently studied the non-audit services provisions in the IESBA Code and strengthened the requirements in certain areas. We believe the revised IESBA Code includes a robust set of safeguards and prohibitions that safeguard independence when providing non-audit services and there is no need to require a further ban on the provision of non-audit services.

It should also be noted that there are benefits from having auditors provide non-audit services to audit clients. The diversity of skills offered by firms enhances the quality and efficiency of the audit and non-audit services performed. Prohibiting audit firms from providing non-audit services to their audit clients could result in clients losing the breadth of knowledge and skills offered by multi-disciplinary firms. In addition, the opportunity to offer non-audit services within a firm enhances the recruitment and retention of high quality professionals. Such a prohibition may result in audit firms no longer being able to attract and retain high caliber professionals.

Finally, as required under the U.S. SEC rules, we would support the pre-approval of all non-audit services provided to listed entities by their audit committees. We also believe that disclosure of

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[5] http://www.iccwbo.org/id598/index.html

[6] http://www.gao.gov/new.items/d04216.pdf and http://www.gao.gov/new.items/d04217.pdf

[7] Available upon request.

fees paid for non-audit services (e.g., in the proxy) for listed entities would enhance transparency and serve as a reasonable safeguard.

Fees – (Q. 20) The IESBA recently studied the issue of significant fees from an audit client and recognized that a self-interest or intimidation threat to independence may exist when the fees from an audit client represent a significant portion of the firm, office or individual partner's revenues. The IESBA issued guidance under its independence standards that requires consideration of threats and safeguards for non-public interest entities and for public interest entities, requires either a pre- or post-issuance review of the engagement when fees exceed 15%. This is consistent with the U.S. SEC's approach to fees which uses 15% of total revenues as a rule of thumb in considering whether independence may be impaired when a significant portion of the firm's revenues are derived from one client or group of related clients.[8] We believe this is a reasonable and effective approach to address the threats to independence. In considering this issue, we urge the EU to be mindful of the differences in a listed entity environment compared to a non-listed interest entity environment and not extend bright line prohibitions to the latter. For listed entities, we would also support the disclosure of audit and non-audit services fees (e.g., proxy disclosure) to enhance transparency.

Governance of Audit Firms (Qs. 21, 22, 23)

The AICPA supports the increased transparency of audit firms introduced under Article 40 of the Directive which requires audit firms auditing public interest entities to publish a transparency report. However, we do not support firm financial statements being released to the public. Specifically, we do not believe that such information will inform readers about the quality of a firm's audit practice nor a firm's ability to provide quality audits. In jurisdictions where national independent audit oversight bodies exist over audits of listed entities, we would support transparency of firm financial information to those bodies and recommend that the oversight body determine the type of firm financial and risk information important to assess audit firm stability and sustainability. It should also be noted that there are many firms whose listed entity audit practices comprise a small portion of total revenues and believe such firms should be excluded from any additional requirements.

In addition, if there is sufficient reason for an audit committee to need the audit firm's financial information, they can certainly request such information and the firm and the audit committee can determine the appropriate information to share based on the specific circumstances.

As far as other governance measures to enhance the independence of audit firms, we recognize that there may be potential benefits to including independent members on firm boards, but believe firms should be given flexibility in determining how this should be applied across the EU. Specifically, any changes to audit firm governance should be done while taking into consideration the many different business models utilized by firms across the EU, with different practices and different sizes. Each firm should maintain the ability to determine the most effective structure for its practice. In addition, we believe any requirement needs to carefully consider the needs of SMPs as not to result in significant costs to comply with additional

[8] "SEC Staff Reply Letter" dated, January 3, 1997 to Weinberg, Pershes & Company, P.A.

requirements that have little benefit to their stakeholders. We therefore generally believe any additional requirements should only apply to audit firms who audit listed entities.

Finally, we do not oppose the Commission exploring alternative structures to the current requirements on ownership and management of audit firms such as those that would allow audit firms to raise capital from external sources provided that any such structures included effective safeguards to protect auditor independence and audit quality.

Concentration and Market Structure (Qs. 27, 28, 30)

We acknowledge that the failure of one or more of the largest audit firms could cause disruption in the global capital markets. While the Commission has already taken significant measures to limit the civil liability of auditors in the EU, we believe the Commission should continue to explore appropriate limitations on auditor liability since this continues to be a significant issue in many countries, especially in the U.S.

We do not support the *mandatory* formation of audit firm consortiums. Furthermore, we believe this type of intervention by the Commission across the EU should require significant analysis (including cost-benefit) to determine whether such a measure would achieve the intended purpose as well as any unintended consequences to the audit market. We do, however, believe the Commission should continue its focus on measures that will assist SMPs with entering the audit market but refrain from taking any action where it intervenes directly in the market since such actions may have unintended consequences.

With regard to promoting SMP's growth in the audit market, we recommend the Commission consider the following:

Public Disclosure of Third-Party Agreements that Limit Auditor Choice
Listed entities should be required to disclose in their annual reports and proxy statements, any provisions in agreements with third parties that limit auditor choice. Such disclosure may help to ameliorate the barrier to entry for SMPs. This type of transparency could create incentives for audit committees to ensure the best choice of auditor and help clarify that size is not the only criterion when selecting an auditor.

Include Representatives of Smaller Auditing Firms in Committees, Public Forums, Fellowships, and Other Engagements
We believe that SMPs should be better represented in committees, public forums, fellowships, and other engagements in order to achieve greater visibility and recognition. SMPs may find it difficult to compete due to a lack of name recognition and reputation and these types of programs can help them achieve visibility.

Other Barriers to Audit Firm Growth that the EC Should Address
As noted earlier, we believe that the single most significant deterrent to SMPs taking on additional listed entity audits is the threat of crippling liability. At least in the U.S., SMPs' desire to expand into the listed entity audit market will be limited until the underlying liability risks are addressed. For example, in the U.S. insurance reforms are needed that enable firms of all sizes to obtain insurance to protect themselves from catastrophic judgments (even large audit

firms are currently unable to obtain adequate liability insurance for such large judgments). In addition, although most SMPs (i.e., regional and local firms) in the U.S. have access to commercially available professional liability insurance, substantial expansion of these firms could result in increased insurance costs, and could ultimately result in insurers being unwilling to provide coverage to these firms.

In addition to the measures described above, regulators and oversight bodies that mandate audits can use their position to advocate using SMPs to audit committees for purposes of the company's audit.

Creation of a European Market (Q. 33)

We support mutual recognition agreements (MRAs) among accounting bodies and regulators to provide cross-border audit rights and believe these are critical to facilitate cross-border mobility of auditors. We also believe that not every professional accountant on the audit team should be required to be licensed in each country rather, only those professional accountants who are assuming responsibility for the audit and signing the report. It should also be noted that the audit is performed by the *firm* and firms are regulated and subject to quality control inspections. In the U.S., firms that perform listed entity audits must register with the PCAOB and are subject to its inspection process. A similar registration process for auditors of listed entities may also prove beneficial throughout the EU.

Simplification: Small and Medium Sized Enterprises (SMEs) and Practitioners (SMPs) (Qs. 35, 36, 37)

The AICPA has provided standards for unaudited services (reviews and compilations) since 1978. In the US, these services are very popular because they provide users with three options depending on their needs. Therefore, we fully support more market options for users depending on their needs and management's costs and benefits analysis. We further believe these options should be provided for SME clients regardless of the internal qualifications of management personnel.

As noted earlier, we do not support future prohibitions of non-audit services and believe the IESBA Code adequately addresses when non-audit services should be prohibited or safeguards needed to mitigate any threats to independence. However, if any future prohibitions of non-audit services are imposed, we would recommend that IFAC's IESBA and SMP Committees consider the need for possible safe harbor provisions applicable to SME clients.

With regard to quality control rules for purposes of a "limited audit" or "statutory review," ISQC 1, as issued by the IAASB is a scalable standard. Therefore, we believe all size firms should follow ISQC 1 (or their national equivalent), however, such quality control procedures can (and should) be tailored appropriately based on the type of assurance service performed.

International Cooperation (Q. 38)

In order to enhance the quality of the oversight of global audit players through international cooperation, we believe there must be mutual recognition between global regulators and ultimately, reliance placed on the home country regulator (e.g., for quality control inspections). This would require communication and sharing of information between regulators and acceptance of the standards and procedures implemented by the home country regulator. Accordingly, it is imperative that regulators across the globe work together towards a common oversight and regulatory framework.

The AICPA appreciates the opportunity to comment on the Green Paper and would be happy to discuss our comments with the Commission. We look forward to participating in the Commission's ongoing debate and study of these issues.

Sincerely,

Paul V. Stahlin, CPA
Chairman of the Board

Barry C. Melancon, CPA
President and CEO