



EUROPEAN COMMISSION
Internal Market and Services DG

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE

Brussels, 04632 03.10.05 12:29
MARKT/2005/13695

Mr. John Kellas
Chairman
International Auditing and
Assurance Standards Board
545 Fifth Avenue, 14th Floor
USA - New York, NY 10 017

Subject: Reaction to the Forum of 11 July 2005 on Clarity

Dear Mr Kellas,

1. We have been delighted to participate to the IAASB Clarity Forum of 11 July 2005. The Clarity project is key to improving the quality of International Standards on Auditing (ISAs). In this respect, all Member States agree on the importance of the "Clarity Project" of the IAASB.
2. Comments in this letter take utmost account of the remarks made by representatives of the Member States of the European Union. For practical reasons we have not been able to consult beyond the national public authorities of the Member States. For the record, we commented previously on the Exposure draft of the Clarity project – our letter of January 2005 to Mr Jim Sylph. As agreed between the Monitoring Group, IFAC and the Commission, we are confident that the IAASB will seek the approval by the PIOB of the overall work program of Clarity.

The endorsement process under the 8th Company Law Directive (state of proceedings as of 5 August 2005)

3. Under the forthcoming EU 8th Company Law Directive on Statutory Audit, the European Union may adopt international auditing standards, using the "comitology" procedure. To do so the Commission has to submit international standards on auditing to Member States, represented within the future Auditing Regulatory Committee (AuRC). But before this, the Commission has to ensure that an overall review of the standards is performed and submitted to the AuRC; this will be a requirement under the 8th Directive, which we expect to see achieved by early 2008. The 8th Directive requires in addition that a technical committee or group on auditing will assist the Commission on the assessment of the technical soundness of

all the international auditing standards, and that such technical committee or group involves the system of public oversight bodies of Member States.

Work program of the IAASB

4. We understand that the IAASB is not able to implement the Clarity project on all ISAs by the end of 2007. However, because of our timing, we suggest that the IAASB delivers “building blocks” before the end of 2007, which would be used for the Commission to successfully start the process described above. Other ISAs could go through the Clarity process after the end of 2007. We would clearly prefer that the timeline currently set by the IAASB for the revision and redrafting of the 2nd wave of ISAs in the tentative agenda provided at the Forum be accelerated, say by the end of 2009.
5. What we mean by “building blocks” is a set of revised ISAs which, altogether:
 - (i) present sufficient consistency so as to perform full audits of financial statements covering the most common cases (see point 6 below);
 - (ii) include the standards where individual Member States consider that an improvement of the quality is necessary (see point 7 below); and
 - (iii) include subjects which will also be dealt with in work programs of important jurisdictions, such as the US, in the coming years until the end of 2007. Whilst the final solutions on either side might differ, we should not lose sight of the international convergence of auditing standards, particularly with new standards to be developed by the PCAOB in the coming years. However principles based standards are of utmost importance for the European Union.

6. The IAASB currently proposes to prioritise the implementation of Clarity on the basis of the extent of revision needed for each standard. Based on our proposal for introducing “building blocks”, we suggest a different prioritisation, as shown in the table below :

2006-2007	2008-2009
ISAs first part of the “building blocks”	ISAs second part of the “building blocks”
Objective and General Principles (ISA 200)	Terms of audit engagement (ISA 210)
Quality Control for Audits of Historical Financial Information (ISA 220)	Audit Considerations Relating to Entities Using Service Organizations (ISA 402)
Documentation (ISA 230)	Audit Evidence—Specific Items (ISA 501)
Auditor’s Responsibility To Consider Fraud (ISA 240)	Audit Sampling (ISA 530)
Consideration of Laws and Regulations (ISA 250)	Consideration of Laws and Regulations (ISA 250)
Communication (ISA 260) *	
Audit Planning (ISA 300)	Initial Engagements—Opening Balances (ISA 510)
Understanding the Entity and Its Environment (ISA 315)	Considering the Work of Internal Auditing (ISA 610)
Materiality (ISA 320) *	Comparatives (ISA 710)
Auditor’s Response to Assessed Risks (ISA 330)	
Audit Evidence (ISA 500)	Analytical Procedures (ISA 520)
External Confirmations (ISA 505)	External Confirmations (ISA 505)
Estimates (ISA 540) *	
Auditing Fair Value Measurements and Disclosures (ISA 545)	Auditing Fair Value Measurements and Disclosures (ISA 545)
Related Parties (ISA 550) (if issued in Sept. 05) *	
Going Concern (ISA 570)	Going Concern (ISA 570)
Representations (ISA 580) **	Subsequent Events (ISA 560)
Group Audits (ISA 600) *	
Using the Work on an Expert (ISA 620) **	
Independent Auditor’s Report (ISA 700)	
Modified Reports (ISA 705) and Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor’s Report (ISA 706) *	Other Information in Documents Containing Audited Financial Statements (ISA 720)
Special Purpose Reports (ISA 701/800)*	Special Purpose Reports (ISA 701/800)*

(*) ISAs Currently Under Exposure

(**) ISAs Currently Under Development

~~Strikethrough~~: ISA which the IAASB considers should be part of this wave, but which we propose to prioritise differently

7. Beyond the implementation of Clarity, various Member States have reported to us the existence of areas where ISAs deserve an improvement in substance. For this reason, the Member States concerned agreed under the 8th Company Law Directive to move to ISAs only if the Directive offered the ability to provide for modified requirements under national law for a transitional period, and afterwards the ability if necessary to perform carve-outs in exceptional circumstances. We report below back to the Board the matters raised so far by the Member States. We invite the Board to address such issues upstream. This would certainly also contribute to higher and consistent audit quality across the EU.

- Case 1: ISA 320 – Audit Materiality. Because this standard does not provide for methods of calculation, it gives auditors full freedom to define any materiality thresholds, thus hindering its enforceability. We expect that revision under way of this ISA by the IAASB will tackle this issue. We welcome the fact that the IAASB considers applying in addition Clarity to this ISA before 2007.

Case 2: ISA 505 – External confirmations. Auditors shall obtain for each audited entity direct confirmation for each bank and related types of accounts, and from each lawyer with which the audited entity has worked. We suggest a change of the IAASB work program so that this ISA is revised before the end of 2007 (see point 6 above).

Case 3: ISA 260 – Communication with those charged of governance. This ISA tends to be written on the basis that those charged with governance could not include executive directors. This may not work for entities with unitary boards, a system which is important in the EU. We expect that revision under way of this ISA by the IAASB will tackle this issue. We welcome the fact that the IAASB considers applying in addition Clarity to this ISA before 2007.

Case 4: ISA 570 – Going Concern. This ISA addresses how an auditor should report on financial statements of companies facing the risk or the inability to continue as a going concern. Management may decide at a certain point in the life of a company to prepare financial statements not using the going concern assumption, because either the company will go bankrupt or has already declared bankruptcy or because of any other cases in which the company is going to disappear. Under paragraph 36 of ISA 570, if the auditor of the company estimates that this decision is appropriate and that the financial statements adequately reflect the situation of the company, he is entitled to issue an unqualified report on the financial statements. This may conflict with the legislation of at least one Member State, either because company law provides that a different type of audit report should be prepared in such cases, or because the law requires no financial statements in such cases. A reform of ISA 570 would help clarify the various scenarios and the auditors' involvement. We welcome the fact that the IAASB considers applying in addition Clarity to this ISA before 2007.

Case 5: ISA 720 – Other Information in Documents Containing Audited Financial Statements. Should the auditor detect mistakes in documents accompanying the annual financial statements (but not part of them), he/she must decide whether to set an emphasis paragraph or not in his audit report. However, according to many of our Member State's regulations, the emphasis of matter

paragraph is used only to stress the existence of exceptional information included in the annual financial statements, and not to issue an opinion on information other than in financial statements. We are confident that revision under way by the IAASB of ISA 706 - Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report and conforming amendments on ISA 700 – Auditor's report and ISA 720 will clarify the use of the emphasis of matter and Other Matters paragraph. We welcome the fact that the IAASB considers applying in addition Clarity to ISA 700, 705 and 706 before 2007, and we suggest a change of the IAASB work program so that ISA 720 is also revised before the end of 2007 (see point 6 above).

Objectives and requirements of the future standards

8. The IAASB came to the Forum with the idea of implementing “objectives” in the ISAs. We can support developing ISAs along those lines, but subject to making very clear that objectives are mandatory. To this extent, we prefer the use of the word “must” in the body of the objective. The wording of the objectives should enable oversight bodies to enforce them in practice. In this way, both a principles-based approach for the setting of standards and their enforceability for public oversight systems could be achieved in an optimal way.
9. Provided that objectives are set as above, we concur with the IAASB's intention to introduce in ISAs “requirements” describing the procedures to be undertaken by auditors in order to achieve the objectives. In drafting requirements, we support using a wording which will convey sufficient authority to ensure that all the necessary procedures are undertaken by the auditors. Still, the wording should also provide the ability to depart from one or more of the requirements, subject to the auditor's professional judgement, in cases where they are not relevant or cannot be undertaken, or due to other circumstances to be defined. Using the single word “shall” for requirements appears to us as the most capable of satisfying these constraints.
10. For enforcement purposes, ISAs should specify a limited number of circumstances when departure is allowed. We support the overarching principle of documenting departures, including the reasons for departure, and by which means the related objective has been reached otherwise. This would follow the model of “comply or explain” of corporate governance codes. However, documentation requirements should remain commensurate with the objectives pursued.
11. The level of authority carried by “shall” and rules for departure have to be clearly defined in the Glossary of Terms section – not in the Preface which could not be endorsed under EU legislation.

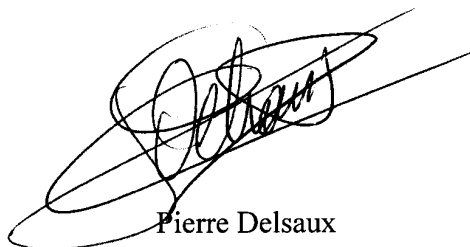
Other aspects

12. We support the structure proposed at the Forum by the IAASB for ISAs. In particular, the following sections are paramount: Objectives, Definitions and Requirements.
13. We strongly believe that ISAs should not be written in a way as to require compliance with – exclusively – the IFAC Code of Ethics. While we support the development of ethical standards applying internationally, some of our Member

States (France, or the UK, just to name a few) have developed and implemented their own code of ethics. The forthcoming Directive on Statutory Audit will not impose the use of a single Code of Ethics.

14. There is concern that the Clarity project may result in additional cost and inefficiency for audits of smaller entities. We encourage the IAASB to explore solutions allowing to tailor the audit to the size and type of the audited entity.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'P. Delsaux', is written over a large, stylized, scribbled-out signature. The signature is positioned above the printed name and title.

Pierre Delsaux
Acting as Director

c.c.: Members of the EU Expert Group on Auditing, Stavros Thomadakis
(PIOB Chair), David Damant (IAASB CAG Chair), Jürgen Tiedje
(European Commission)