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Mr. Michel Barnier
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European Commission
BERL 10/034, B - 1049 Brussels
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JICPA Comments on the European Commission's Green Paper,
Audit Policy: Lessons from the Crisis

The Japanese Institute of Certified Public Accountants ("we", "our" and "JICPA") is grateful for the opportunity to comment on the European Commission's (EC) Green Paper, *Audit Policy: Lessons from the Crisis* ("GP"). The GP includes comprehensive discussions regarding audit, which may also influence the audit system in jurisdictions outside the EU. Although we are a professional accountancy body in the jurisdiction outside the EU, as one of international partners within the auditing profession in the world, we would like to participate in this debate. Based on our discussion, we would like to provide our views on certain of the questions that we consider significant, raised in the GP.

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

(Comment)

We agree that the financial crisis has raised the question to all market participants, including auditors, to review their respective roles. As an audit profession, we would always appreciate to participate in constructive discussion and make positive change which will contribute to the public interest. However, regarding the general approach of the GP, we have the following concerns:

1. The auditor's responsibilities regarding the financial crisis

The audit is conducted on an individual entity. On the other hand, the risks which gave rise to the financial crisis were present across the entire markets, rather than being confined to a specific entity. Although we believe that the audit profession can discuss about our future role as one of the market participants, and improve its role in the context of constructive discussion about the future; the auditors, themselves, could not have prevented or detected the systemic risk as well as the financial crisis and, therefore, the issue of audit system itself was not a cause of the financial crisis.

However, when reading the GP as a whole, it appears that there is a presumption that the audit profession itself was responsible for some aspects of the financial crisis, and the financial crisis revealed the failure of the audit system. If the audit system is significantly reformed based on this perception, in the longer term, there might be significant adverse effects on the quality of the audit of financial statements, which has long been recognized as a valuable service. Therefore, we are concerned that it might result not to protect the public interest.

2. Market Concentration

The discussions stated in the GP regarding market concentration include measures which require regulatory intervention. As stated below, in the longer term, regulatory intervention to the market might cause significant adverse effects on audit quality. Therefore, we believe that the issue of market concentration should be addressed by market based measures, which tend to take gradual and sustainable effect, rather than addressed by regulatory interventions (Please see our comments to the Questions 17, 28 and 29 below).

3. Consistency between the international frameworks/principle-based approach

In order to maximize the effectiveness of the capital markets, it is necessary that the regulatory framework, including accounting and auditing, is consistent internationally as much as possible. Therefore, new measures need to be considered in light of the discussion being made at various international arenas (Please see our comments to the Questions 4, 5, 7 and 8 below). In addition, although the importance of the principle-based approach, rather than rule-based approach, has been emphasized in the current environment, the GP includes several measures with features of a rule-based approach. Even if a certain measure which features rule-based approach is appropriate in a certain jurisdiction, it is not necessarily appropriate in another jurisdiction, depending on the respective circumstances (Please see our comments to the Questions 18, 19 and 20 below).

We have responded to the detailed questions as follows:

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

(Comment)

The current purpose of financial statements audit is for the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and express an opinion regarding fair presentation of the financial statements. Therefore, at present, except for the limited procedures carried out with respect to the going concern issue, the audit work is focused on the examination of historical financial information, and the auditor does not have the responsibility to express an overall opinion relating to the financial health of the entity. We believe that the scope of the financial statements audit as described above is appropriate, and we are cautious about its revision. This is due to the fact that financial statement audits have long been recognized as a valuable assurance service which is applicable to all entities regardless of their size or jurisdiction in which they are located.

On the other hand, we believe there may be scope for considering new services to be provided by the audit profession on information beyond the financial statements to provide comfort or assurance, on the financial health of companies. In this respect, we have the following observations:

1. Division of responsibilities between management and the auditor

We believe that it is vital to maintain the framework of division of responsibilities (i.e. the entity's management is responsible for the preparation of the subject matter information; and the auditor is responsible for the assurance on it). This framework incorporates fundamental valuable features, which include: the auditor who is independent of the entity provides the assurance; and the auditor discusses the findings, and challenges the subject matter information prepared by management, which will result in the improvement of the quality of the financial reporting. Therefore, the consideration of the auditor's responsibility beyond the current financial statements audit system should be discussed within this framework.

2. Establishment of relevant framework

It is necessary for entities, as well as auditors, to establish a relevant framework so that the entity will be able to prepare the information, and the auditor to provide assurance on it. This includes the followings:

i) Establishment of suitable criteria and the assurance standards

It is necessary to establish suitable criteria for the entity to prepare subject matter

information, and the assurance standards for the auditor to examine it. In addition, these need to be developed at an international level in order to achieve cross-border comparability.

ii) Consideration of liability protection

Future-orientated information, such as overall statements related to the entity's financial health has a high degree of estimation uncertainties, compared to historical financial information. Therefore, it is necessary to consider the effect of potential liability risk of entities and auditors, as well as safeguards for entities and liability protection for audit firms.

3. Cost-effectiveness

If management prepares the information beyond the current financial statements, and the auditor provides assurance on such future oriented information, extra costs will be incurred resulting from the additional information. Therefore, we believe there needs to be clear evidence that benefits from the change will exceed the costs to be incurred by the stakeholders.

Your 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?

(Comment)

We agree that there remains an expectation gap regarding the role of the auditor, and there need to be continuing efforts to bridge this gap. Regarding this matter, the International Auditing and Assurance Standards Board (IAASB) has initiated/plans to start projects relevant to bridging the expectation gap, and in order to clarify the role of the audits. This includes; the Auditor Reporting Project; and the new project which is to consider the publication of a document to explain the meaning of an audit. In this context, we believe that it is especially critical to achieve international consistency of format in auditors' reports, which are available beyond the relevant jurisdiction, in order to promote its credibility in the global market place and enhance the credibility of financial reporting.

Therefore, relevant stakeholders need to deal with this issue on internationally consistent basis. On this point, we are willing to continuously make a positive contribution to relevant projects of the IAASB.

In addition, the GP states that "The Commission notes that the statutory audit has evolved from substantive verification of income, expenditure, assets and liabilities to a risk based approach.", and "The Commission wishes to explore the case for "going back to basics" with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work...".

We believe that the risk-based approach is essential not only from a cost-benefit perspective but also in relation to the enhancement of the quality of the financial statements audit. Through the risk-based approach, the auditor is able to focus the work effort on high risk areas, which enhances the quality of the financial statements audit. We believe that the current financial statements audit, which is based on a risk-based approach, is appropriate and delivers reasonable assurance on the fair presentation of the financial statements. Therefore, this approach should not be changed.

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

(Comment)

Please see our comments to the Question 5 above.

Your Question 8: What additional information should be provided to external stakeholders and how?

(Comment)

Please see our comments to the Questions 4 and 5 above.

Your 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?

(Comment)

The objectivity of auditors is safeguarded by the overall framework which surrounds the auditors, including, among other things, the code of ethics and regulatory transparency disclosure. In addition, the Code of Ethics for Professional Accountants published by the International Ethic Standards Board for Accountants (IESBA) has adopted the principle-based approach which is based on "threats and safeguards approach". In this approach, a professional accountant in public practice takes reasonable steps to identify circumstances that could pose a conflict of interest, evaluates the significance of any threats and applies safeguards when necessary. It does not simply depend on the fact that the auditor is appointed and remunerated by the audited entity. We believe that current comprehensive framework has the following benefits, and therefore, it should be retained:

1. It enables an entity to respond to its circumstances, through its own choice of an auditor.
2. It promotes the improvement of audit quality through establishment and maintenance of an audit firm's relevant quality policies and procedures, as well as development of the audit firm methodology. (Please see our comment to the Question 17 below)

Your Question 17: Would the appointment by a third party be justified in certain cases?

(Comment)

Generally speaking, in the financial statements audit system, we doubt that the appointment by a third party is justified in certain cases. At the stage of acceptance and continuance of client relationships and audit engagements, based on the firm's quality control policies, the audit firm conducts procedures which are relevant to the following considerations: the firm's competencies and capabilities to perform that engagement; whether the firm can comply with relevant ethical requirements; and the integrity of the client. In addition, the audit fee is determined directly through negotiation between the audited entity and the auditor based on the entity's audit risk consideration. If, a third party, such as a regulator appoints the auditor and determines the audit fee, instead of direct negotiation between the audited entity and the auditor, we are concerned that, in longer term, there may be significant adverse effect on audit quality, since the audit firm may lose incentive to make investments directed at the improvement of audit quality. This includes establishment and maintenance of relevant quality control policies and procedures, as well as development of the audit firm methodology.

The Green Paper also states that "the Commission is considering the feasibility of a scenario where the audit role is one of statutory inspection wherein the appointment, remuneration and duration of the engagement would be the responsibility of the third party" and "...such a concept may be especially relevant for the audit of the financial statements of large companies and/or systemic financial institutions".

We believe that even in the case of large companies and/or systemic financial institutions, the appointment and remuneration by a third party is not justified. This is due to the fact that, even if the role of audit of the systemic financial institution is decided to be closer to a statutory inspection, as stated in our comment on the Question 1 above, it would be difficult to avoid or detect the cause of the financial crisis through the audit itself. Rather, in the longer term, it is likely that there will be significant adverse effect on the audit quality.

Your 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?

(Comment)

We believe that it is not appropriate to limit the time of continuous engagement of audit firms. As stated in our comment to the Question 16 above, the objectivity of auditors is safeguarded by the overall framework which surrounds the auditors, including the code of ethics and regulatory transparency disclosure. Also, in the IESBA's Code of Ethics for

Professional Accountants, which was revised in 2009, the mandatory rotation requirements on certain personnel were expanded, including the key audit partner provisions in respect of an audit of a public interest entity, in order to enhance auditor's independence. The mandatory rotation of the audit firms has the following drawbacks:

1. There may be increased risks that the auditor cannot detect relevant issues, since there is limited accumulation of knowledge and experience regarding the audited entity.
2. It will increase the required costs and time for entities, as well as audit firms, as follows:
Audit firms - for the initial audit engagement, there would be more costs and time incurred, as compared to the continuing audit engagement.
Entities - the costs and time to choose a new audit firm as described above, and the necessity to support the incoming audit firm.
3. Since the audit clients would be periodically and automatically rotated off, there would be a lower incentive for the audit firm to make investment related to improvement of audit quality, including establishment and maintenance of relevant quality control policies and procedures, as well as all development of the audit firm methodology. Consequently, in the longer term, there would be significant adverse effect on the audit quality.

Your 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?

(Comment)

There are non-audit services which are not appropriate to render by the auditor to an audit client, and we believe that providing such non-audit services should be prohibited. In fact, the IESBA's Code of Ethics for Professional Accountants prohibits the auditor to provide specific non-audit services to audit client, and we believe it is necessary to continuously revisit the ethical code in order to reflect the changes in circumstances. However, we believe that blanket prohibition of all non-audit services from the auditor to an audit client is not appropriate, because of the following reasons:

1. There are some non-audit services which clearly do not compromise the auditor's objectivity.
2. By the auditor providing certain non-audit services to the audit client, there is positive effect on the audit quality, as follows:
 - i) The audit team can enhance its understanding of the entity's operation, risk and objectives, as well as the management.
 - ii) The audit firm needs to have the resources that have necessary capacity and skill

to provide non-audit services. Such diverse resources are also important on the audit engagement.

3. Providing certain non-audit services by the auditor to an audit client is also of benefit to the audit client, since the auditor, who has the understanding of the client through the audit engagement, can provide valuable service in terms of its quality and efficiency.

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

(Comment)

When the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, it may create a self-interest or intimidation threat which compromise the independence, and in such situation, we believe it is necessary to apply appropriate safeguards. However, if a specific limitation for the proportion of fees an audit firm can receive from a single audit client which prohibits the audit firm from conducting the audit is provided, it results in narrowing down the entity's choice of an auditor (for example, large entities may not able to request an audit to be done by small and medium sized audit firms), which will harm the public interest. The significance of the threat will be dependent on the respective circumstances such as the operating structure of the firms. Therefore, we believe it is not appropriate to establish specific limitation for the maximum level of fees an audit firm receives from a single entity.

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

(Comment)

We do not believe the current ownership rules are an obstacle for the audit firm to obtain appropriate funding, since the audit firm is able to use bank loans, as necessary. On the other hand, allowing audit firms to obtain funding through equity finance, for example, has the following drawbacks:

1. The external shareholders may make a decision from a perspective of market considerations (i.e. pressure from short-term profit oriented intention), which will adversely affect the audit quality.
2. Independence considerations between the external shareholders and the audit clients will be necessary. This will significantly complicate the framework of the system relevant to the independence issues, and it will narrow down the entity's choice of an auditor.
3. If an influential and large financial institution becomes the external shareholder of the

audit firm, there is a risk that this will heavily impact on many audits.

Your 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 small and medium-sized firms to participate more substantially in the segment of larger audits?

(Comment)

It is doubtful that a 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. This is because even if a small and medium sized audit firms are mandated to be included in the larger audit, in substance, major parts of the audit work will be performed by the larger audit firm, which will only artificially increase the number of players in the larger audit market. And, in the longer term, it will not necessarily result in the enhancement of the competitiveness of the small and medium sized audit firms. In addition, we believe that mandatory formation of an audit firm consortium has a number of drawbacks, as follows:

1. There may be cases where the appointment of more than one audit firm is not feasible because of the independence issues (for example, in the case for an audit of a large financial institution)
2. If there is more than one audit firm auditing a financial statements of one group, there might be increased risk that the auditors will not detect the material misstatements, since there will be no one auditor who has a whole picture of the group, which might adversely affect the audit quality. Especially, the entity may more easily conceal fraud since the audit responsibility is in fact split between different audit firms.
3. The audit firms will need to understand respective policies and procedures, and coordination efforts will be necessary in order to work together in one group audit. Also, the entity will need to make arrangements so that the audit firms are able to coordinate their work. Therefore, it will result in extra costs and time for the audit firms as well as the entities.
4. If the formation of an audit firm consortium becomes mandatory, this will narrow down the entity's choice of the auditors. The entity should have a right to choose its auditor taking account its circumstances.

We would like to inform you that the use of a joint audit is permitted in Japan. However, it has been used in limited circumstances, such as in the case of a business combination. If entities expected that a joint audit would have benefits in excess of the cost incurred, we believe the entities would use the joint audit more frequently. Although the joint audit has benefits in certain circumstances, it has drawbacks as stated above. Therefore, from our

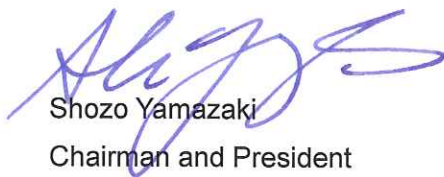
experience, we believe an entity should have a right to make its own decision taking into account its circumstances.

Your 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?

(Comment)

Mandatory rotation of audit firms after a fixed period has, as stated in our comment to the Question 18 above, a number of drawbacks. Also, if mandating tendering, there may be excessive downward pressure on audit fees, which will adversely effect audit quality. In addition, even if the rotation of the audit firms after a fixed period becomes mandatory, it will not resolve the issue of market concentration without the entities choosing audit firms other than big 4. And therefore, in order to dynamize the audit market, the appointment by a third party (Question 17) or joint audit/formation of an audit firm consortium (Question 28) would also need to become mandatory in addition to the mandatory rotation of the audit firms. However, as stated above, there are a number of drawbacks. Therefore, we believe that it is not appropriate to mandate the rotation accompanied by the mandatory tendering in the context of dynamizing the audit market.

Yours truly,



Shozo Yamazaki

Chairman and President

The Japanese Institute of Certified Public Accountants