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Dear Sir/Madam

Enhancing the Value of Auditor Reporting: Exploring Options for Change

We very much welcome the IAASB paying attention to the issue of auditor reports. As an investor, we share many of the concerns with the current nature of auditor reporting which the IAASB identifies, and have played a significant role in developing the UK approach to this issue which appears to form one of the bases of the IAASB work.

Please find enclosed the Hermes Equity Ownership Services response to the above consultation. By way of background, Hermes is one of the largest asset managers in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including Lothian Pension Fund, The National Pension Reserve Fund of Ireland, PNO Media (Netherlands), Canada's Public Sector Pension Investment Board and VicSuper of Australia; (only those clients which have expressly given their support to this response are listed here).

We believe that there is a need for enhanced disclosure by management, those charged with governance, and auditors, and that the combination of such enhanced disclosure will be significantly improved dynamics in the relationships between all three parties. The core of our proposals in this respect is laid out in the table under question 11. The increased challenge and questioning this will engender should drive better quality corporate reporting as well as audit reporting. It will thereby lead to heightened investor confidence in individual companies and also in markets as a whole. We firmly encourage the IAASB to take these steps to capture these very significant benefits.

Yours sincerely,

Paul Lee
Director

HERMES

Issues Identified

1. Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?

We believe that generally this is a good summary of the perceptions around the audit and issues in relation to auditor reports. In particular, we believe that the discussion of the information gap is extremely helpful. We would note our strong view that the concern about an expectation gap is significantly over-stated and has had a pernicious impact on auditor reports. Driven by a traditional understanding of the expectation gap, audit reports spend more time indicating what the audit does not do than they do in explaining what the auditors have done; this generates a perception gap which significantly damages the standing of the auditing profession. This perception gap is reinforced by the lack of transparency about audit quality in current auditor reports. The perception gap encompasses the issues raised in the paper but goes beyond this because it highlights the damage that the profession does to itself and investor views of its value by the negative tone of audit reports and their lack of focus on audit quality. We believe that better auditor reporting about what has been done would address both this perception gap and the expectation gap as generally understood.

2. If respondents believe changes in auditor reporting are needed, what are the most critical issues to be addressed to narrow the information gap perceived by users or to improve the communicative value of auditor reporting? Which classes of users are, in the view of respondents, most affected by these issues? Are there any classes of users that respondents believe are unaffected by these issues?

To respond to the IAASB analysis and to that in our response to question 1 above, we believe that three things are fundamentally necessary:

i. Audit reports need to drop any and all language which highlights what the audit does not do and what the auditor has not done. This includes the boilerplate about management and auditor responsibilities.
ii. Audit reports need to include a report on the auditor's conclusion in respect of all the elements that the standard audit delivers, whether these are matters of positive or negative assurance. All too often the breadth of the auditor's work is not made apparent in the report, which again does the profession a disservice.
iii. The auditor should provide more disclosure that is specifically relevant to the company. Our thoughts in this respect are considered in more depth below.

We believe that audit reports which deliver this will be of substantially more value to all users of financial reporting. We do not believe that there are users for whom such communication would not be of value – though because of the perception gap there are many who currently ignore audit reports.

3. Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities?

We believe that these issues are most acute in the context of listed companies, given the division between ownership and management inherent at such businesses. However, the concerns apply more generally and so all entities would benefit from enhanced audit reports.

Exploring Options for Change

A. Format and Structure of the Standard Auditor's Report

4. Respondents are asked for their reactions to the options for change regarding the format and structure of the standard auditor's report described in Part A. Do respondents have comments about how the options might be reflected in the standard auditors report in the way outlined in Appendix 1 of this Consultation Paper?

Given our views on the expectations gap, it is perhaps not surprising that we would be willing to see the descriptions of management and auditor responsibilities removed from auditor reports. They form part of our description of the audit report being more about what the auditor does not do than about what the auditor has done. As the paper notes, users simply do not read these paragraphs and so, even for those who believe the expectations gap is a substantive issue, they serve no practical purpose in this respect.

Our favoured approach would be the first option, described in paragraph 41, of relocating the paragraphs to a separate place. They could then be made more complete without getting in the way of users accessing the opinion, which the paper is right in noting as the most important element of the audit report. This venue – presumably an official website - could also be used to clarify the language which the paper indicates as being technical and as a barrier to mutual understanding.

5. If the paragraphs in the current standard auditor's report dealing with management and the auditor's responsibilities were removed or re-positioned, might that have the unintended consequence of widening the expectations gap? Do respondents have a view regarding whether the content of these paragraphs should be expanded?

We do not believe that this proposed change would have a significant impact on the expectations gap and, to repeat, we believe it would help address the much more pernicious perceptions gap. As the paper notes, these paragraphs are not currently read and so have no substantive impact in reducing this supposed gap currently. As noted above, we would be comfortable in seeing an expansion of the paragraphs and a further elucidation of the technical language – though, to be clear, we would not support this being done if the paragraphs remain within the audit report as we fear this would get in the way of users accessing and understanding the much more important elements of that report.

B. Other Information in Documents Containing Audited Financial Statements

6. Respondents are asked for their reactions to the possibility that the standard auditor's report could include a statement about the auditor's responsibilities regarding other information in documents containing audited financial statements. Do respondents believe that such a change would be of benefit to users?

As indicated above, we believe that the audit report should include an indication from the auditor of its view in respect of all its various responsibilities, which include the read requirement, but would also extend to the going concern responsibility and others. We would not welcome a statement of what these responsibilities are – such a requirement risks introducing new boilerplate to the audit report. Rather, we believe that the UK model has much to recommend it – a brief reference to the responsibility (which can be elucidated in more detail as part of the auditor responsibilities paragraph) and an indication of the auditor's view in respect of that responsibility, whether in the form of negative or positive assurance or statements.

7. If yes, what form should that statement take? Is it sufficient for the auditor to describe the auditor's responsibilities for other information in documents containing audited financial statements? Should there be an explicit statement as to whether the auditor has anything to report with respect to the other information?

We do not believe that it is sufficient to outline the responsibilities – indeed we believe that this would introduce unhelpful boilerplate – we believe that it is necessary to include an explicit statement as to the auditor's view in respect of each of these relevant responsibilities. That statement is needed whether the auditor's role is one of positive assurance or simply reporting if it has become aware of a discrepancy, and any level of responsibility in between these two extremes.

C. Auditor Commentary on Matters Significant to Users' Understanding of the Audited Financial Statements, or of the Audit

8. Respondents are asked for their views regarding the auditor providing additional information about the audit in the auditors report on the financial statements.

We believe that there would be real value in considering enhancing auditor reports in this way. However, we believe that this needs to be done with real care to strike the right balance of ensuring fuller, more useful disclosures to investors while also leaving the balance of responsibilities placed appropriately between the auditor and the board. To take each of the individual possible suggestions in turn:

- <u>Key areas of risk of misstatement, including critical accounting estimates and areas of measurement uncertainty</u>. We believe that such matters should already be disclosed by issuers as part of their standard reporting, and we do not believe that it should fall to the auditor to disclose this afresh unless the auditor believes that the audited entity's disclosures are inaccurate or inappropriate. We thus believe that the auditor should make a disclosure to the effect that it supports the audited entity's disclosures - and highlight where each of the mentioned elements can be found. Only where the auditor does not believe the audited entity's disclosures are full and appropriate will it need to make disclosures which fill relevant gaps. Naturally, this process will apply an important and necessary discipline on the quality of the disclosures which issuers make.
- <u>Areas of significant auditor judgement</u>. We would note that the areas referred to under this bullet point could probably be more clearly referred to as areas of accounting judgement. We believe that this is an area where in the absence of specific disclosures to this effect by the audited entity (in which case we believe that the auditor could simply respond to these disclosures with an opinion in the form of a negative assertion – "we have nothing to add to the company's disclosures" or the like), the responsibility for disclosure does lie with the auditor, and so we believe that auditors should be prepared to highlight the list of the key accounting judgements in respect of the individual audited entity.
- <u>Level of materiality</u>. We are not convinced that a disclosure on the level of materiality per se would generate useful disclosures. However, we believe that what those users who have made the call for such disclosure are in practice seeking is some insight into the key judgements in relation to the audit itself - such as which subsidiaries

are audited directly and which are not and how such decisions were taken; significant risks identified at the start of the audit; and reliance on another auditor or on the work of internal audit. We believe that this is crucial information for generating investor confidence in the quality of the audit, and demonstrating the quality of the audit, and that this is an area where the primary responsibility for disclosure lies with the auditor.

- Internal controls. We believe that any such disclosure requirement invites auditors to undertake work which is significantly beyond the boundaries of the audit in most jurisdictions. We would note that the other categories of disclosure proposed here are of information which arises simply through the nature of the audit process itself, and that this is not true where a disclosure on the quality of internal controls is sought. We would therefore not support a requirement for such disclosure in the audit report - to do otherwise would in effect potentially introduce further substantive audit obligations by implication, something we regard as wholly inappropriate.
- Areas of difficulty in the audit. This will be a sensitive matter around which disclosures risk intruding into the relationship between the auditor and the audited entity, and particularly the relationship with those charged with governance. We do believe that there is real value in disclosures of a brief list of the key areas of discussion between the auditor and those charged with governance - the value principally being that this will build confidence in the minds of shareholders that both the auditor and those charged with governance are performing their tasks effectively. However, we believe that the primary responsibility for such disclosure should sit with those charged with governance, and that the auditor's role can only be an opinion (probably in a negative form such as “we have nothing to add…”) that these disclosures are an accurate and fair portrayal of their discussions.

9. Respondents are asked for their reactions to the example of use of “justification of assessments” in France, as a way to provide additional auditor commentary.

The French approach is worthwhile and helpful to users to the extent that it provides insights that are genuinely company-specific rather than generic for the business sector as a whole. The moment such disclosure becomes boilerplate it loses all value. On the whole we feel that the lengthy, discursive nature of these disclosures is less helpful than a short, even bullet-point highlighting of the key judgements and risks. We therefore believe that it is worth exploring more fully the sorts of disclosures discussed under question 8 above before pursuing in depth a model such as this one.

10. Respondents are asked for their reactions to the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor’s report.

There is an ongoing debate about whether the basis for IFRS accounting should be a neutral approach or a prudent approach. Our impression is that it is unlikely that we will return to a prudent approach. If this is the case, a neutral approach to accounting standards places a significant burden on the shoulders of the auditors: in our view they are already under an obligation only to sign off accounts if they genuinely do represent a neutral approach to reporting the performance and state of the audited entity. Rather than seeking a disclosure of the auditor's view of the relative conservatism or aggression of the entity's accounts we believe that - if the reporting framework is one based on neutrality - the auditor should be obliged to make a statement as part of its audit report that the accounts are a neutral representation. We believe that this would have a powerful disciplining effect on those managements with a tendency to aggression in their accounting, and remind all parties of the nature of the representation which is being sought through the accounting process.

On the whole we believe that this disclosure would be a more powerful and useful leverage point in discussions between the auditor and the audited entity than the disclosures highlighted in the second and third bullet points in paragraph 72. We also note it should not add to the auditor’s burden as neutrality is something of which the auditor already needs to assure itself before signing off the audit.

We have already indicated that the audit report standard should not introduce any new substantive audit obligations by the backdoor, and that we are concerned that requiring auditor disclosures with regard to internal controls would in effect do this. We therefore do not support the proposal within the first bullet point.

Finally, we do not believe that the auditor is an appropriate party to make judgements or statements about governance structures or the quality of management. In addition, any obligation to do so would risk undermining the relationship between the auditor and the audited entity.

D. An Enhanced Corporate Governance Model: Role of Those Charged with Governance regarding Financial Reporting and the External Audit

11. Respondents are asked for their reactions to the options for change relating to an enhanced model of corporate governance reporting, as described in Section III, Part D.

As indicated above, under question 8, we believe that this approach has merit. More useful disclosures on the audit process and audit quality will help start addressing the perception gap around the audit and emphasise audit quality in a way which over time will increase competition over audit quality and we welcome better disclosures by all parties to corporate reporting. This is both necessary and important. But it is extremely important to focus on which parties have the primary responsibility for disclosure. We provide a brief table which we think provides a helpful insight into our thinking on this matter.

<table>
<tr><th></th><th>Management</th><th>Those charged with governance</th><th>Auditor</th></tr>
<tr><td>Financial accounts</td><td colspan="2">Primary responsibility</td><td>Audit opinion</td></tr>
<tr><td>True and fair view</td><td colspan="2">Primary responsibility</td><td>Audit opinion</td></tr>
<tr><td>Neutrality</td><td colspan="2"></td><td>Primary responsibility</td></tr>
<tr><td>Associated narrative reporting</td><td colspan="2">Primary responsibility</td><td>Read requirement – negative assertion (“we have nothing to add”)</td></tr>
</table>

Adequate books and records/internal controls	Primary responsibility		Positive statement
Going concern	Primary responsibility, including to disclose key risks and process for arriving at going concern view		Secondary responsibility – exceptions opinion
Key accounting judgements	Primary responsibility		Highlighting existing disclosures, negative assertion (“we have nothing to add”)
Key assumptions and estimates	Primary responsibility		Highlighting existing disclosures, negative assertion (“we have nothing to add”)
Key auditing judgements		Commentary on auditor disclosure and discussion of role in assisting auditor in reaching those judgements	Primary responsibility
Key areas of debate & discussion between auditor and those charged with governance		Primary responsibility	Commentary, negative assertion (“we have nothing to add”)

This implies that there are indeed matters which those charged with governance - very usually the audit committee - have the primary responsibility for disclosing, and we strongly encourage the development of regulatory regimes which facilitate and encourage such disclosure.

12. To the extent that respondents support this model, what challenges may be faced in promoting its acceptance? Also, what actions may be necessary to influence acceptance or adoption of this model, for example, by those responsible for regulating the financial reporting process?

The primary challenge is that already highlighted in the paper, the significant differences internationally between governance models. Addressing this, and applying additional disclosure standards to those charged with governance in different regimes, goes beyond the remit of the regulators of the financial reporting process. Generating effective change will require cooperation with a whole range of regulatory bodies and will be a slow process on a global scale. It is for this reason that audit regulators may need to set disclosure requirements of the auditor if the audited entity has not already made some of the disclosures which we suggest above are the entity’s primary responsibility.

13. Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?

We believe that if those charged with governance make disclosures of the form envisaged then the auditor should express an opinion - probably in the form of a statement that the auditor believes this is a fair description and has nothing to add - in respect of it.

E. Other Assurance or Related Services on Information Not Within the Current Scope of the Financial Statement Audit

14. Respondents are asked for their reactions to the need for, or potential value of, assurance or related services on the type of information discussed in Section III, Part E.

We do not believe that it is necessary to develop such an assurance model - indeed we fear it would amount to a dangerous distraction from the core role of the auditor and the core role of the audit regulators.

With regard to the listed items, our views are: that it would be wholly inappropriate and unhelpful to auditors to make any judgements or statements about the quality and nature of corporate governance, and about the sustainability of the business model; we have already indicated our clear view that the audit should not be extended to detailed internal controls assessments; and we believe that the auditor role in relation to disclosures about the business model, risk management and KPIs is best captured by the read requirement rather than any more extensive assurance approach - though we would note that we expect any auditor carrying out the read requirement in an effective manner will inevitably need to pay particularly close attention to these areas of disclosure.

15. What actions are necessary to influence further development of such assurance or related services?

As indicated, we do not believe that these are areas that should be pursued.

16. Respondents are requested to identify benefits, costs and other implications of change, or potential challenges they believe are associated with the different options explored in Section III.

We have already sought to indicate in our responses to the earlier questions our thinking on where the burden of these responsibilities appropriately lies, and we have also commented on the behavioural implications of our proposed approaches. We thus have nothing to add here other than to state our clear view that these steps would deliver much better reporting to shareholders, such that the benefits in terms of market confidence would be substantial.

17. Do respondents believe the benefits, costs, potential challenges and other implications of change, are the same for all types of entity? If not, please explain how they may differ.

We believe that the costs and benefits of the approach we have discussed will be largely proportionate and appropriate across all entities.

18. Which, if any, of the options explored in Section III, either individually or in combination, do respondents believe would be most effective in enhancing auditor reporting, keeping in mind benefits, costs, potential challenges, and other implications in each case? In this regard, do respondents believe there are opportunities for collaboration with others that the IAASB should explore, particularly with respect to the options described in Section III, Parts D and E, which envisage changes outside the scope of the existing auditor reporting model and scope of the financial statement audit?

We believe that the proposals we make above are not unduly burdensome but that their benefits would be substantial in refocusing attention on audit quality and addressing the perception gap. We thus believe that these should be pursued with some vigour. They will require in some cases cooperation with the IASB and governance regulators, and so may take time to work through the regulatory system. This is even more reason to begin the process as early as possible.

19. Are there other suggestions for change to auditor reporting to narrow the "information gap" perceived by users or to improve the communicative value of the auditor's report?

We have no further recommendations to add.