



ICGN

International Corporate Governance Network

By web submission: www.iaasb.org

James Gunn
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue
New York, NY10017
USA

16 September 2011

Dear Mr. Gunn

Re: Consultation input on ‘Enhancing the Value of Auditor Reporting’

We are writing on behalf of the International Corporate Governance Network (ICGN). The ICGN is a global membership organisation of institutional and private investors, corporations and advisors from 50 countries. Our investor members are responsible for global assets of U.S. \$18 trillion.

The ICGN’s mission is to raise standards of corporate governance worldwide. In doing so, the ICGN encourages cross-border dialogue at conferences and influences corporate governance public policy through ICGN Committees. We promote best practice guidance, encourage leadership development and keep our members informed on emerging issues in corporate governance through publications and the ICGN website. Information about the ICGN, its members, and its activities is available on our website: www.icgn.org.

The purpose of the Accounting and Auditing Practices Committee (A&A Practices Committee) is to address and comment on accounting and auditing practices from an international investor and shareowner perspective. The Committee through collective comment and engagement strives to ensure the quality and integrity of financial reporting around the world.
http://www.icgn.org/policy_committees/accounting-and-auditing-practices-committee/

Thank you for the opportunity to comment on the Consultation Paper issued by the International Auditing and Assurance Standards Board (IAASB), ‘**Enhancing the Value of Auditor Reporting: Exploring the Options for Change**’.

The ICGN wishes to express our support for the IAASB’s review of auditor reporting and including issues that ‘go beyond the independent auditor’s report’¹. We are pleased to provide comments on some of the issues you have raised. In particular, we are encouraged by the IAASB consulting the wider investor community to understand better the value of auditor reporting and to seek suggestions for possible improvements.

¹ IAASB, *Consultative Document - Enhancing the Value of Auditor Reporting: Exploring the Options for Change*, paragraph 11, IAASB, New York 2011.

General Perspective

We continue our commitment to best practices that contribute to the efficiency and effectiveness of capital markets, including credible, high quality financial reports which serve the needs of investors and other users of financial information. The integrity and quality of financial reports is supported and strengthened by a robust external independent audit, carried out objectively and undertaken with professional scepticism on the part of the auditor.

Any developments/additions suggested in this response or that follow from the Consultation Document should not detract from the main objective of the current style of audit report – to give an opinion as to whether the financial statements present a true and fair view of the position of the entity.

Currently the external audit function appears to serve the interests of management and boards more than investors and this is a missed opportunity by auditors in providing useful information to investors. We believe auditors need to focus more on providing investors with improved confidence in the integrity of the information in the Financial Statements and in the Annual Report. For example, the auditor is a technical expert on financial reporting and verification and should be well-positioned to judge objectively a company's approach to risk and control.

However, the current Audit Report is a standardised, formulaic, comforting compliance statement rather than as a source of valuable information to investors. We would encourage the provision of an expanded audit report that includes further information on:

- the audit process and what the auditor actually did;
- if non-audit services were provided to the company, a statement from the auditor regarding how the auditor ensured that these additional services did not present a conflict of interest and impair auditor independence; and
- the quality of the financial statements, including a statement on the level of conservatism in accounting decisions and analyses of risks.

In this context, a number of oversight bodies, especially when considering the recent financial crisis, have commented on a lack of auditor scepticism. The UK's Audit Inspection Unit (AIU) commented on the inadequacy of professional scepticism in audit firms and audit teams in its Annual Report 2009- 2010. The UK's Financial Services Authority commented on a 'worrying lack of scepticism' on the part of auditors.

Professional scepticism is critical to investor confidence and is about having a challenging, questioning approach to the audit by all on the audit team. This approach should be documented during the audit, be evident from the audit report and inspected by audit oversight bodies.

Making the Auditor's Report more informative is an ongoing objective of ICGN. In addition, the ICGN agrees with the IAASB in its discussion of the 'expectations gap' and believes it is time to address this issue. It has been a topic of discussion by audit standards setters for a considerable period of time.

In particular there is an 'expectations gap' regarding the auditor's responsibilities relating to fraud. The ICGN believes that efforts should be made to

address this, at least in part, through the development of enhanced professional standards. Professional standards should be expected to accord with the highest standards internationally and certainly not an average or lowest common denominator approach.

The focus of any changes in auditor reporting should be the value to investors. Regulators and lenders have other mechanisms at their disposal to require the provision of information and should not be the focus of attention here. In addition, changes to the existing auditor report or that introduce a new style of auditor report, such as the AD&A, should be cognisant of and related to any changes in integrated reporting and the general reporting framework.

Options for change

To Enhance the Usefulness of Auditor Reporting

ICGN's response to the UK's Financial Reporting Committee on Effective Company Stewardship considered many of the issues in this consultation document. The relevant extract is reproduced below.

"We continually seek to improve the audit model to ensure independent, high quality audits by auditors and audit firms. Auditors should serve as independent gatekeepers that instil public confidence via high quality audits in public companies seeking capital from investors.

We strongly believe that the role of the auditor is to address whether the financial statements present a true and fair view of the financial health of the company at balance sheet date and that it is reasonable that accounts are prepared on a going concern basis ensuring that the company is able to pay its debts as they fall due for (at least) the next twelve months, *ceteris paribus*.

The existing audit report offers investors with an impression of the auditor's view on the financial statements and the basis of that view. It is a snap-shot opinion that the financial statements at year end properly reflect the financial condition of the company at that moment. For the purpose of investors' investment decision making, further information on the audit process (what the auditor actually did) and the quality of the financial statements (level of conservatism in management accounting decisions, analyses of risks) should be included in the audit report. This would make the audit report more meaningful, instead of a statement of minimal value including disclaimers."

And:

"A number of investors would value auditors providing a reasonable and balanced assurance on matters in narrative reports, including certain CSR information and would like an 'Auditor's Discussion and Analysis' (AD&A) or a 'Letter to the Shareholders' to provide them with the auditor's independent perspective on key risks. In this AD&A auditors could give information on:

- Key business, operational and audit risks the auditor believes exist, and which the auditor has considered when conducting the audit;
- The auditor's perspective on what are the key assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low, most likely, or high end of the range of possible outcomes;

- The appropriateness of the accounting policies adopted;
- Changes to accounting policies that have a significant impact;
- The methods and judgments made in valuing assets and liabilities;
- Unusual transactions;
- Accounting applications and practices that are uncommon to the industry;
- Identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit;
- Key audit issues and their resolution which the audit partner documents in a final summary audit memo;
- Quality and effectiveness of the governance structure and risk management (including internal controls); and
- The completeness and reasonableness of the Audit Committee Report.

Others fear that this could result in boilerplate reporting and dumb down the information disclosed. These investors would thus welcome the audit committee reporting on the process followed in ensuring the narrative reports are accurate and complete, and the auditor commenting on the committee's report."²

ICGN believes that investors would benefit from improved financial reporting, a better quality external audit and improved reporting by Audit Committees (see comments below relating to the enhanced governance model).

Below we focus on the issues that we believe are critical from the perspective of institutional investors. ICGN represents and as such, we do not comment on issues specific to SMEs and Public Sector entities, other than to encourage high quality financial reports for all entities with an external ownership structure.

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

Location of the Auditor's Opinion

The ICGN does not consider a change in the position of the audit report to be important, except to state that the audit report should be attached to the financial statements.

C. Auditor Commentary

Going Concern- Emphasis of Matter

An illustration from the recent financial crisis is relevant. For example, in the recent financial crisis, one bank having a December 2007 year end received a 'clean' audit report, signed off in February 2008, and its financial statements gave no indication of future financing problems only one or two months prior to the company seeking financial support to continue as a 'going concern'. We believe the auditor should have given some warning on the imminent nature of the foreseeable problems perhaps in an 'Emphasis of Matter' paragraph.

² ICGN, *Letter to the UK Financial Reporting Council*, 30 March 2011, ICGN London 2011.

Increased information and insights

The ICGN considers the proposals for additional information in the Audit Report stated in paragraph 62 of the Consultation Paper are appropriate. In addition, the ICGN supports the proposal that the auditor should share insights and perceptions relating to the quality of the entity's financial reporting as stated in paragraph 72 of the Consultation Document. Additional information disclosed by the company and audited and reported on by the auditor should meet the following criteria:

- Preserve the distinction of duties between the board, including the audit committee, management and the auditor and enhance communication between these parties.
- Be presented in a transparent, consistent and objective way and be integrated with the national financial reporting laws, regulations and framework
- Appreciate the technical nature of the terminology used and perhaps a glossary of terms be provided to clarify the terms.

Material Inconsistencies

To the extent the auditor becomes aware of 'material inconsistencies' between the information in the financial statements and in the 'other information' presented by the entity, it would be valuable if they were highlighted in the auditor's report.

D. An Enhanced Corporate Reporting Model

The Consultation Paper rightly identifies that various models exist for enhanced reporting, of which an AD&A is one. ICGN supports the fact it avoids conclusions about which model is 'best' in that different legal and cultural environments may favour different models. For example, UK respondents may be more disposed towards the Financial Reporting Council's approach of enhancing reporting from audit committees with auditor's having a role in giving assurance on those disclosures. North American responders may favour a 'through the eyes of the auditor' primacy in the reporting model. The key matter is that the IAASB should facilitate enhanced reporting of various approaches and not form a prescriptive view at this stage as to what is best practice.

In any event and for clarity, we would encourage the maintenance of a clear distinction on three levels of auditor reporting:

- between auditor' reporting on the financial statements;
- auditor reporting on broader company information; and
- auditor reporting on the audit process itself.

Reporting by the Audit Committee

A report from the company's audit committee to the shareholders, investors and other users on its activities and communications with the auditor would complement the Auditor's Report and should reflect the particular responsibilities of those charged with governance of the entity. The audit committee's role is to oversee the integrity of the company's financial reporting.

The ICGN believes that the enhanced model of corporate governance as described in paragraph 81 to paragraph 86 and especially highlighted in Diagram 3 is an appropriate model for the relationships and communications between the external auditor and governance of the entity.

If you would like to discuss any of these points, please do not hesitate to contact Carl Rosén, our Executive Director, at +44 (0) 207 612 7098 or carl.rosen@icgn.org. Thank you for your attention and we look forward to your response on the points above.

Yours sincerely,



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