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Subject: Eumedion response to the Consultation Paper on Enhancing the Value
of Auditor Reporting: Exploring Options for Change
Ref: B2011.37
Amsterdam, 16 September 2011

Dear Mr. Gunn,

We welcome the opportunity to submit comments on the International Auditing and Assurance Standards Board (IAASB) consultation paper 'Enhancing The Value of Auditor Reporting: Exploring Options For Change'. By way of background, and to put our comments in context, Eumedion is the Dutch based corporate governance forum for institutional investors with interests in Dutch listed companies. Our 69 Dutch and non-Dutch participants - with a long term investment horizon - have together more than EUR 1 trillion assets under management.

Summary

We are very pleased with the publication of this high quality consultation paper. We believe that the paper covers the most important aspects of audit reporting. The paper proposes well balanced improvements in corporate and audit reporting and enhanced transparency around the roles played by the external auditor and audit committees respectively, both which are critical to good corporate governance. Enhanced transparency allows investors to act as engaged shareholders and to make sound judgements that would support the efficient functioning of capital markets.

The external, independent auditor is a well-positioned expert to judge objectively a company's approach to risk and control. If need be, the external auditor can challenge management's judgement on accounting elements and assessment of risk. It is the external auditor who has the statutory duty to report to shareholders and other users of annual accounts whether the company is presenting a true and fair view of the financial position. In order to facilitate optimal asset allocation, the investor's analysis is dependent on this audit opinion.

Whilst we trust that many audits are effective, we recognise that material improvements should be made in the audit processes and in the quality of audit reports. The potential for improvements should be considered profoundly. The primary role of the audit of the financial statements is to sufficiently inform the company's shareholders and other stakeholders. We are concerned that this primary responsibility has been diluted. Sometimes, it looks like the auditor is more aligned with the interests of the management board than with the users of the annual accounts.

Although audits do offer a degree of comfort to shareholders and other providers of capital, the content and output of the audit are largely opaque. This certainly applies to the main binary audit opinion, which provides little underlying detail, but is also evidenced by the limited use of 'emphasis of the matter' and 'other matter' paragraphs and absence of references to other core elements of the audit, such as the assessment the risks facing the company and the input, judgments and assumptions by the management.

We believe that the IAASB together with other bodies such as the European Commission could play a major role in encouraging better reporting by both companies and external auditors. The quality and the findings of the audit must be made more transparent to investors and other stakeholders. The ultimate clients of the audit must be enabled to get more insight into the work of the external auditor. Only then confidence in the annual accounts and financial reporting in a broader sense can be restored.

In our view the reform should include the following elements:

Expanded information on the entity and financial reporting quality

As the primary (non-)financial reporting responsibility rests with the board, it should deliver in-depth information to investors and other users about the business of a company, its strategy and the risks related to this strategy. We expect boards to give a fair view of the key risks (not only financial risks, but also strategic, operational, governance, sustainability and compliance risks and a combination of risks) which are material for achieving business objectives in the Management Discussion & Analysis (MD&A). If the board fails to do so on material aspects, the

auditor should have the responsibility to 'alert' shareholders and other users on the risk profile on his own initiative, based on his professional judgment, in the emphasis of matter or other matters paragraph.

Audit committee

The audit committee has a major role to play in the financial reporting and audit process. We believe the audit committee's value could be further strengthened through increased disclosure and transparency. Enhanced transparency regarding the matters collectively dealt with by auditors and those charged with governance regarding financial reporting is highly desirable. This can be achieved by putting in place an expanded and meaningful audit committee report. This would help to restore what is now sometimes an imbalance within listed companies' annual accounts. This renewed audit report will specifically disclose (i) the key assumptions used in judgments that materially affect the financial statements and (ii) issues raised in the course of the audit as mentioned in the management letter and the appropriateness of the response of the management and (iii) the basis for its conclusion that the annual report, viewed as a whole, is fair and balanced. The auditor should have an independent role in attesting the reasonableness and completeness of this relevant information provided by the audit committee. For this purpose the audit report may also be complemented by an emphasis of matter or other matters paragraph.

Expanded information on the audit

In the context of the audit, the auditor should regular report on its actual work and process, including:

- The extent to which reaching the audit opinion has involved issues with a high degree of uncertainty, including both the positive and the negative reassurances given to users;
- The meaning of "reasonable assurance" in the context of that specific audit;
- His work and findings on other information in documents containing audited financial statements.

Non-financial information

Good quality non-financial information, including information on governance, risk management and internal control systems and sustainability, is of the same order of paramount importance as financial information. An independent assurance is needed to ensure the quality and credibility of reported non-financial information. The external auditor – with involvement of the internal auditor – is rightly placed for performing such a task – as are other service providers able to provide independent assurance. However, whether the assurance is provided by the external auditor or others would be a matter of choice taking into account the specific position and relevant circumstances of the company.

In relation to the consultative questions we would comment as follows.

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 IAASB has quite clearly identified and acknowledged the key issues regarding the public perception of auditor reporting. High quality financial reporting is essential to ensure that investors have sufficient, relevant and reliable information upon which to base investment decisions. With its duty to report on whether the company presents a true and fair view of the financial position, the external auditor significantly supports the quality of financial reporting.

We recognise the so called information gap mentioned in the consultation paper. There is much more relevant information available about the company and the audits conducted than is currently being disclosed. We realise it not realistic to expect, given the nature of financial reporting and audits, all relevant private information to be disclosed. But the gap could be narrowed significantly by a combination of additional disclosures by the company and by including more information in the audit report.

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?

The provision of relevant, reliable and understandable information is clearly the responsibility of company's management and board of directors. The disclosed information, like the financial statements, should reflect a company's considered view of the information that investors and other users need. Notwithstanding that responsibility of companies for the quality and completeness of the annual accounts and other disclosed (non-)financial information, we believe that the auditor report could become much more relevant and useful for investors. For the purpose of investors' investment decision making, further information on the audit process (what the auditor actually did) should be disclosed. Only with such information users are able to answer and weigh the conclusions of the audit as reflected in

the audit opinion. This would make the auditor report a true report, instead of a statement with a minimum of informational value and a maximum of disclaimers. We believe that institutional investors, investing in listed companies, are most exposed and affected by the lack of information. Shareholders and other users that already receive additional information (for instance a limited group of shareholders of non-listed smaller company) are expected to be less affected by the information gap.

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

Given Eumedion's objective, our answer is confined to listed companies. We generally believe that creating a more useful and informative audit reporting environment is in principle relevant and beneficial for all listed companies and their stakeholders. We also see merit in the principle of consistent reporting by all listed entities, regardless their size and where their shares are listed or traded. At a time when business and the provision of finance of both large and smaller companies is becoming increasingly complex and fast changing, investors need reliable well-interpretable information about the business of the company involved, its strategy and key risks. Investors need to have confidence in the integrity and reliability of that information. This confidence could be reinforced by a more effective and transparent audit regime. Less informative audit reporting for smaller listed companies could refrain investors from paying more attention to those companies' performance and future prospects.

Format and Structure of the Standard Auditor's Report

4. Do respondents have comments about how the options might be reflected in the standard auditor's report in the way outlined in Appendix 1 of this Consultation Paper?

As far as the explanation of Management and Auditor Responsibilities (ISA 700) is concerned, we would not support to remove these paragraphs entirely from the audit report. Information on the respective responsibilities could be helpful for user's adequate understanding of the audit opinion, especially for less sophisticated users and thereby help to narrow the information gap. At the same time, wording to generally describe the directors' and auditor's responsibilities and what the audit is about, could be considered as somewhat redundant and potentially confusing. Especially as financial statements are now often accessed through the internet, there are other ways in which the information on responsibilities (including disclaimers) could be provided. Thus, we would support auditor reports containing clear references to where the information on responsibilities can be read.

This would help focus attention on more company-specific audit information.

With regard to the use of technical language (e.g. materiality, fair presentation and reasonable assurance) we think that it will add value when the meaning of the technical language is explained by enclosing clear links in the audit report to jargon descriptions to be published on supervisory authorities websites. This could result in a better understanding and more enlightened perception of the nature and significance of the terminology used in audit reports such as 'emphasis of matter' and the 'qualified opinion'. To address the situation, the IAASB should develop proposals to promote a global framework of audit report terminology that is less binary and more discerning.

We do not have strong views on the location of the opinion in the auditor report. We feel confident with the current practice of presenting the opinion in the final paragraph, as long as the information in the entire audit report would provide investors with real value (we refer to our response on Q8 and Q 10).

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?

We believe that if the paragraphs on management and responsibilities were to be replaced by a clear link to the relevant website where the information can be read instead, the expectation gap would not be significantly widened. More specifically, removing unnecessary wording of what the external auditor generally does and does not will create space to enlighten investors and other users of financial reporting to the specific findings regarding the audited entity in question. The latter could contribute to narrowing the expectation gap.

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?

Yes, we believe such a change will benefit users. Under ISA 720, the auditor is not obliged to include information in the audit report on his work vis-à-vis other information in documents containing audited financial statements. Only in the extreme event of a management refusing

to make a necessary revision of the other information, the auditor has the possibility to describe the material inconsistency in the other matters paragraph. Consequently, only in very limited circumstances users are provided with information on the auditor's efforts on relevant 'other information'. Including those important sources of information, like information on strategic risks and the major operational risks related to the company's business model.

Therefore, we would support initiatives for more customary and explicit statements in the auditor's report regarding the auditor's work on other information, as this would provide investors and other users with more clarity. The audit report should identify 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. This will give greater transparency to the work carried out by auditors in relation to the annual report as a whole.¹

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?

A general description on auditors responsibility for other information containing audited financial statement could serve investors' understanding of auditors' role towards that other information. In addition we would suggest including a new section in the audit report that identifies specifically any matters in the annual report that are incorrect or inconsistent with the information contained in the financial statements.

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 auditor's report on the financial statements.

We believe that there is a case for providing greater transparency about the work and process of the audit. This is particularly important in view of the changing issues facing auditors, in particular the increasing size and complexity of business, the increased emphasis on fair value and risks, since the introduction of IFRS, and the importance of

¹ Financial Reporting Council, 'Effective Company Stewardship: Next Steps', September 2011, p. 14.

professional scepticism.

This enhanced report might include:

- The extent to which reaching the audit opinion has involved issues with a high degree of uncertainty, including both the positive and the negative reassurances given to users.
- The meaning of “reasonable assurance” in the context of that specific audit.
- The key management judgements for which significant auditor judgement was necessary.
- The level of materiality applied by the external auditor to perform the audit.
- Areas of significant difficulty encountered during the audit and their resolution.
- His work and findings on other information in documents containing audited financial statements.

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.

We are not really familiar with the French model. Based on the information in the consultation paper, we believe that auditor’s transparency on his procedures in the key areas of the financial statement may add value for users. It could improve the informative value and complement the pass/fail nature of the opinion. It could also help to narrow the expectation gap. It is important that the additional format is understandable and not too complicated. Also, we are concerned about potential information overload: it should not make it more difficult for readers of audit reports, nor raise any questions which are not really relevant. Information about the entity should in principle not be disclosed, as distribution of this type of information is solely the responsibility of company’s management and board.

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.

Unlike the audit itself (see question 8), we do not believe that auditor should be the primary vehicle for greater transparency about the entity or the quality of its financial reporting. We believe that the responsibility for increasing this transparency should rest with the company and that the most appropriate way to transmit it to users is via the annual report, the MD & A or, where appropriate, the report of the audit committee.

In the annual report, the board should provide a fair view of the risks (not only financial risks, but also strategic, operational, governance, sustainability, remuneration and compliance risks and a combination of risks) that are material for the continuity of the business. The board

should also discuss the most important issues of the external auditor in relation to the audit of the financial statements and how these issues were addressed. If the external auditor believes it is important to 'alert' shareholders on specific financial or non-financial risks that are crucial for a true and fair view of the company's health and its continuity, he should use the emphasis of matter paragraph more regularly. He should also have this possibility if he believes that the board does not provide a fair view of the risks and/or believes that his issues are not addressed in an appropriate way. The above also implies that the external auditor should review the annual report – especially the risk paragraph and the audit committee's report – in a more extensive and in-depth way than he currently does.

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.

We note that it is important to have regular and open communication between the audit committee, the internal auditor and the external auditor, prior to, during and after the audit. In doing so, the external auditor must position himself as an independent external expert on critical and complex issues. This will help to ensure that the audit is not purely compliance driven, with auditors adopting a de minimis checklist approach. The dialogue should not be limited to material audit findings, but also include key elements like governance, compliance and risk monitoring.

We would very much welcome enhanced transparency regarding the matters collectively dealt with by auditors and those charged with governance regarding financial reporting. If additional information is to be provided, we think that the Section III Part D model as to how this should be achieved is well formulated. As it is the responsibility of the company to communicate with users at first instance, we believe the primary focus should be on the audit committee's report as the conduit for this information. An expanded and meaningful audit committee report would help to restore what is now sometimes an imbalance within listed companies annual accounts.

Subsequently, the external auditor should check whether material issues raised in the course of the audit are appropriately reflected and discussed in the MD&A and/or audit committee report and that the annual report is fair and balanced. This could be reflected in an expanded audit report. We refer also to our answer to question 8.

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?

There are a number of challenges. First of all, the quality of the audit committee should meet high standards. It has appeared that audit committees have suffered from a lack of expertise and current knowledge on audit and accounting issues. To bear the responsibility of overseeing the financial reporting process and build a fruitful dialogue between the internal and external auditors and the audit committee, it is a key prerequisite that the audit committee has sufficient capacity on board.²

Secondly, it is important that the day-to-day executive management, in particular the CFO, allows and facilitates the audit committee overseeing the financial reporting and audit process. Also, the external auditor should be required to provide the audit committee with the information that the committee needs to fully understand the factors that the external auditors relied upon in exercising their professional judgement.

Thirdly, we believe it is important that audit committees and external auditors, in carrying out their respective duties, have proper privacy to achieve effective communication which will be in the ultimate best interest of the company and its shareholders and other stakeholders. We definitely think that greater transparency than currently exists can achieve a better balance (see response to Q11 above), but it is also essential that audit committees have flexibility to determine the right balance between transparency and confidentiality.

Finally, it will be vital that the enhanced disclosure does not turn out to be largely 'boiler-plate' and/or consist of a general description of the audit committee's activities.

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

We do not believe a prescriptive requirement regarding auditor's assurance of audit committees' reports will be necessary. We would expect that the auditors should be obliged to report if there is anything in the audit committee's report that is not complete, reasonable and/or is inconsistent with the auditor's experience of the audit process. We refer to our answer to question 8.

² Enhanced Disclosure Working Group, *Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners and Investors*, January 2009.

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.

Good quality non-financial information, including information on governance, risk management and internal control systems and sustainability, is of the same order of paramount importance as financial information. Institutional investors rely on these types of information to enhance their understanding of the financial statements and the company's performance and future prospects. High quality non-financial reporting is of great importance for the companies as well. A company aiming to stay in business in 50 years from now, must incorporate a sustainable strategy today and report on this. The non-financial information will by nature often be more varied and more forward looking and will be based on a number of assumptions. An independent assurance is needed to ensure the quality and credibility of reported non financial information.

The auditor is rightly placed for performing such a task – as are other service providers. Whether the assurance is provided by the external auditors or other providers would be a matter of choice. However, it must be clear that external auditors need to build new skills on non financial levels while maintaining their technical accounting and auditing knowledge and skills when they aim to offer valuable assurance services regarding non-financial information.

Because of the absence of general standards on non-financial information and given their diverse nature, we believe it is difficult to be prescriptive and require external auditor by law to deliver an assurance opinion regarding non financial information. However, if the audit committee and/or investors of a individual company thought it appropriate, non-financial information could be the subject of a separate assurance report. Examples might include key performance indicators, the company's business model, and management of risks.

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

Requirements by law regarding auditor assurance on non-financial information would only make sense when general accepted standards or key performance indicators were to a much larger extent adopted than currently is the case. Consequently, the ongoing developments with respect to these standards and key performance indicators should be brought further before considering requirements on auditor assurance.

Implications of Change and Potential Implementation Challenges

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 recognise that there will be additional efforts and, therefore, cost as a result of the proposed:

- expanded communication by the external auditor to the audit committee;
- expanded audit committee report.
- expanded audit report regarding the audit process (Section III, C), audit committee reporting and MD & A (Section III, D), consistency and result of verification other and/or non-financial information (Section B and E).

There can be also be understandable reluctance by companies to provide additional information regarding the entity and the audit quality. This could take additional management time and require more care in meeting regulatory requirements on disclosures to market participants. However, we are convinced that the benefits in terms of increased confidence in corporate reporting and audit quality outweigh the costs involved in such additional regulation. The increased confidence creates value of itself, for example through reducing risk and thereby the cost of capital, and this results in increased financial health of the economy.

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.

Eumedion's primary objective is to promote corporate governance in listed companies and, in relation to that, to foster reporting quality and audits quality regarding these companies. Notwithstanding this objective, we believe that the change of reporting and auditing standards should apply to the audits of all companies and not to a selection. We acknowledge the need for audits to be proportionate in relation to companies of all sizes. To this end, it may be helpful if the IAASB and other standard setters involved would adopt guidance to assist the application of the reformed framework is also included within SME companies.

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 would like to refer to our response to Q6, Q8, Q10 and Q11. In summary, we believe that additional information about the company and its quality of financial reporting (preferably disclosed by the company itself), about the work and findings of the auditor (disclosed by the audit committee and auditor) and about non financial information would be most desirable. The implementation of these proposals would lead to improved confidence of stakeholders in the relevance and independency of the auditor's work.

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 believe the information gap will never be bridged entirely but there is undoubtedly scope to narrow it. As noted above in our response to Q6 and Q8, the information gap could be narrowed by making the audit report much more useful and relevant and by enhanced disclosures of the company's management and the audit committee.

Beyond that, we note that it may be helpful if the dialogue between audit committees and institutional investors would be encouraged. Currently, there is hardly any dialogue between institutional investors and audit committees. This is a significant omission within the framework for effective corporate governance and high quality audits. Such a dialogue could take place on a regular and maybe sector wide basis, conducted under conditions that do not give rise to market abuse. Such an approach would be beneficial for both audit committees and investors.

At present, there is not any requirement for auditors of listed companies to communicate with shareholders when auditors have material matters of concern. For instance only in a few countries, including the Netherlands, corporate governance codes determine that the external auditor has to be present in the general meeting to answer possible questions and give any comments on the financial report in relation to the audit conducted. In our opinion, the lack of an international requirement for auditors to speak with shareholders is an important failure in the existing framework and needs to be addressed. We would welcome if the IAASB in collaboration with other policy makers on corporate governance, would work on appropriate requirements for cases when the external auditor of a listed company and the company's shareholders wish to communicate.

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Wouter Kuijpers (wouter.kuijpers@eumedion.nl); tel. + 31 20 7085882)

Yours sincerely,

Rients Abma
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