



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

24 September 2012

Dear Mr. Gunn,

Re: IAASB - Invitation to Comment (ITC) – Improving the Auditor’s Report

Thank you for IAASB’s Invitation to Comment (ITC) on Improving the Auditor’s Report. We are writing on behalf of the International Corporate Governance Network (ICGN). The ICGN is a global membership organisation of over 600 institutional and private investors, corporations and advisors from 50 countries. Our investor members are responsible for global assets of US\$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 its Committees. We promote best practice guidance, encourage leadership development and keep our members informed of 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 (AAPC) 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/

The ICGN wishes to express our support for the IAASB’s dedicated and continuing endeavour to enhance the relevance and value of auditor reporting. We believe that the suggestion made in the ITC strikes the right balance between the need for internal consistency and comparability in auditor reporting with the need for auditors’ reports that are relevant in the context of the local market. In particular, we are encouraged by the IAASB consulting the wider user community to better understand whether the possible changes would meet investors and other users’ needs. We are pleased to provide some general comments as well as comments on the specific questions in the document.

General comments

Making the Auditor's Report more informative and narrowing the expectation gap is an ongoing objective of ICGN. The ICGN agrees with the IAASB, it is time to address the intensive call for changes and lay the foundation of the future of auditor reporting on the scope of an audit under the current ISAs.

However, reforming the audit report alone is not sufficient. To ensure relevant, reliable and understandable information is provided in Annual Reports the role played by management as well as the audit committee are just as important. Enhanced disclosures enable institutional investors to act as engaged shareholders and to make sound judgments. We believe that the IAASB together with other bodies such as the SEC, UK Financial Reporting Council and ESMA should all play a major role in encouraging better communications by both companies and external auditors.

Investors rely heavily on management's disclosures and the integrity and quality of financial reports is supported and strengthened by a robust external independent audit, carried out objectively and where scepticism is exercised on the part of the auditor. The external auditor should challenge management's judgment in relation to accounting estimates made and its assessment of risk. The external auditor has the statutory duty to report to shareholders whether the financial statements present a true and fair view of the financial position. Investor's analysis and confidence in the capital markets is dependent on this audit opinion and its "pass/fail" nature.

However, the audit report as a whole contains little underlying detail and investors consider it could provide more entity specific information. The latter 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 continuity and the judgments and assumptions made by management. 'Change therefore is essential.'¹

The focus of 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, Introducing a new style of auditor report, such as the proposed Audit Commentary, should be cognisant of and synchronized with reforms in integrated reporting and the reporting framework more broadly.

While we acknowledge that audits throughout various jurisdictions are not necessarily carried out under the same standards, we believe that a more consistent and robust application of the International Standards on Auditing (ISA) would be critical to make the new style of auditing reporting really helpful for investors.

Question 1

Overall, do you believe the IAASB's suggested improvements sufficiently enhance the relevance and informational value of the auditor's report, in view of possible impediments (including costs)? Why or why not?

ICGN believes that IAASB's suggestions for improvement would significantly enhance the relevance and value of the auditor's report, while not resulting in unreasonable impediments. The suggested 'building blocks' approach should ensure

¹ ITC, chairman statement, p. 1.

that comparable auditors' reports are developed internationally, while still leaving the various jurisdictions the ability to tailor auditor reporting requirements to local circumstances. The proposed concept of 'Auditor Commentary', when properly used, together with the proposed auditor statements regarding 'other information' will lead to greater transparency and help meet the information needs of institutional investors. Also the proposed auditor conclusion on the statement on going concern has added value, as it gives investors more clarity on the ability of the entity to continue as a going concern.

Question 3

Do you believe the concept of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report? Why or why not?

ICGN supports the proposed concept of Auditor Commentary. The concept offers external auditors an appropriate framework to provide additional, entity specific information regarding the financial statements and audit conducted, without affecting the auditor opinion. Rather, ICGN believes the Auditor Commentary may improve the value and complement the pass/fail nature of the opinion.

In practice 'emphasis of matter' and 'other matter' paragraphs are rarely used, while many investors seek better understanding of the audit process and what is most important within the financial statements. ICGN expects the new concept could meet these needs and provide for better disclosures. It should draw attention to certain matters from those that are "*fundamental* to users' understanding of the financial statements" to matters "*likely* to be most important to users' understanding of the financial statements".

We agree that Audit Commentary should not be used as a substitute for (a) either a qualified or an adverse opinion (b) or management's responsibility to make required disclosures in the financial statements.

ICGN urges that a standardized and too extensive provision of Auditor Commentary would diminish the effectiveness auditor communication on key audit matters. Therefore, it is vital to allow flexibility for the external auditor to determine which key audit matters are most relevant to users' understanding of the audit. But it should also be made clear that auditor should always consider including in the commentary information on the important aspects of his audit, such as materiality and the scope of audit, and important findings on the financial statements.

Question 4

Do you agree that the matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, with guidance in the standards to inform the auditor's judgment? Why or why not? If not, what do you believe should be done to further facilitate the auditor's decision-making process in selecting the matters to include in Auditor Commentary? 1 (See paragraphs 43–50).

ICGN generally agrees. The external auditor should be allowed to determine which matters are important to address in Auditor Commentary for users' understanding of the financial statements and the audit process. **Notwithstanding auditor's discretion, we believe that, at the minimum, the auditor should always consider including in the commentary information on the important aspects of the audit, such as materiality and the scope of audit, in addition, important findings on the financial statements, like significant management**

judgment, significant unusual transactions, and difficult or contentious matters during the audit. ICGN supports IAASB approach to develop guidance for auditors to help them to make informed decisions in determining the information to include in Auditor Commentary.

Question 5

Do the illustrative examples of Auditor Commentary have the informational or decision-making value users seek? Why or why not? If not, what aspects are not valuable, or what is missing? Specifically, what are your views about including a description of audit procedures and related results in Auditor Commentary?

ICGN believes that the five illustrative examples on page 10 make clear that the concept of Auditor Commentary may have additional value for institutional investors and other users. The examples, topics, content and tone show that the concept offers flexibility and could be tailored to the entity's circumstances based on the auditors' judgment of what is important for users.

However, we consider that the current example to a large extent refers to the financial statements. In essence it is a company's management that are responsible for the financial statements and this is an opportunity for the auditor to comment on his work and the audit process. For instance, the extent to which reaching the audit opinion has involved issues with a high degree of uncertainty and also the most important matters discussed with the audit committee.

ICGN would welcome a description of certain aspects of audit procedures followed in the Audit Commentary. This is important for users' understanding of the audit, as long as the related result (s) are accompanied in the Commentary. In this respect, example 3 (Valuation on Financial Instruments) appears to be more comprehensive than example 4 (Audit Strategy to the Recording of Revenue).

Question 6

What are the implications for the financial reporting process of including Auditor Commentary in the auditor's report, including implications for the roles of management and those charged with governance (TCWG), the timing of financial statements, and costs?

ICGN believes the implications for the financial reporting process should not be overstated. Audit Commentary will be prepared and issued by the auditor, not by the entity, and should in principle refer to topics presented or disclosed in the financial statements only. In addition, as mentioned in paragraph 42, the new concept of Auditor Commentary is consistent with and builds upon the existing concepts of Emphasis of Matter and Other Matter paragraphs. Hence, we believe Audit Commentary will not significantly affect the existing roles and responsibility of management in financial reporting process. Entity's management will continue to be primarily responsible for the provision of relevant, reliable and understandable financial reports. The TCWG's (audit committee or board of directors) role could be strengthened through increased transparency through the Audit Commentary, as any matter to be addressed would be subject to prior discussion in the committee and with the auditor.

With regard to costs, ICGN is convinced that the benefits in terms of increased confidence in corporate reporting and audit quality will outweigh possible additional costs associated with the preparation of Audit Commentary. The increased

confidence creates value of itself, for example through reducing risk and thereby the cost of capital, which results in increased financial health of the economy.

Question 7

Do you agree that providing Auditor Commentary for certain audits (e.g., audits of public interest entities (PIEs)), and leaving its inclusion to the discretion of the auditor for other audits is appropriate? Why or why not? If not, what other criteria might be used for determining the audits for which Auditor Commentary should be provided?

We support the new style of Audit Reporting being applied to Public Interest Companies (PIEs), including listed companies. Given ICGN's perspective, we do not comment on non-PIEs other than to encourage that enhanced auditor reporting is relevant and beneficial for all entities with an external ownership structure.

Question 8

What are your views on the value and impediments of the suggested auditor statements related to going concern, which address the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified? Do you believe these statements provide useful information and are appropriate? Why or why not?

IAASB suggests that auditor should include in all audit reports:

- (i) a conclusion regarding the appropriateness of management use of the going concern assumption
- (ii) a statement on whether or not material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern have been identified.

ICGN believes that these proposals would be helpful and informative to investors, as the external auditor will be required to provide explicit statements on the entity's going concern judgments in terms of appropriateness and material uncertainties in all audit reports.

However, there are various interpretations about what constitutes a going concern. Also, the description of a material uncertainty as "a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern [for the foreseeable future]" is unclear. A clear and consistent definition internationally and across the international accounting and auditing standards and Company Law would be important to the interpretation as to what a material uncertainty and the foreseeable future is.

ICGN would support the IAASB engaging in discussion with other national and international accounting and auditing standard setters and the European Commission, on this.

In addition, we would support that the discussion of strategy and risks in the annual report always includes, in the context of that discussion, the management's going concern statement and how they arrived at it. This approach was recommended in the UK Sharman Inquiry, published in June 2012. We believe there would be considerable benefit to application on a wider, international scale and to accommodate the approach in the ISAs.

Question 9

What are your views on the value and impediments of including additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statement that no material uncertainties have been identified?

In principle, ICGN believes that when the external auditor judges that non material uncertainties have been identified, there is no need to include additional information to support this statement. Potential information overload should be avoided ('cutting the clutter'). However, under certain circumstances adding additional information may have value, as in situations when the external auditor has determined that no material uncertainties exist, despite the fact that events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern (described in paragraph 30).

While ICGN believes that information about the entity should in principle not be disclosed by the external auditor, a different situation may appear when the auditor has identified material uncertainties with respect to going concern that have not been disclosed properly in the financial statements as mentioned in paragraph 31. In such a case, ICGN would expect the external auditor to disclose these uncertainties in his going concern statement in the interests of the users as the ultimate beneficiaries.

Question 10

What are your views on the value and impediments of the suggested auditor statement in relation to other information?

ICGN supports the suggested requirement to include an explicit statement in audit reports on whether material inconsistencies in the audited information and other information have been identified. Also important is the proposal to specifically identify the other information read by the auditor. When the auditor has identified a material inconsistency for which revision is necessary and management refuses to make a revision, the auditor statement on other information should imply a detailed explanation as highlighted in appendix 2, paragraph 2.

The suggestion to include a disclaimer that the auditor has not audited the other information as part of the audit might also add value in terms of avoiding misinterpretation of the works and findings of the auditor.

Question 11

Do you believe the enhanced descriptions of the responsibilities of management, TCWG, and the auditor -in the illustrative auditor's report- are helpful to users' understanding of the nature and scope of an audit? Why or why not? Do you have suggestions for other improvements to the description of the auditor's responsibilities?

ICGN supports the suggested enhancements to the description of the auditor's responsibility in explaining more fully the concept of a risk-based audit, thereby clarifying the technical terms in the framework of an ISA audit. A sophisticated description of the auditor's responsibilities in relation to specific matters could be of great value for many institutional investors (e.g. fraud, internal control, accounting policies and estimates; structure and content of the financial statements and disclosures).

Question 14

What are your views on explicitly allowing the standardized material describing the auditor's responsibilities to be relocated to a website of the appropriate authority, or to an appendix to the auditor's report?

Notwithstanding the relevance of descriptions on responsibilities, standardized wording in the audit report itself to fully describe auditor's tasks and what the audit is about, could be considered as somewhat redundant. Especially as financial statements are now often accessed through the internet, there are other ways in which the information on auditor's responsibilities (including disclaimers) could be provided. Thus, ICGN would support allowing auditor reports to make references to entities and audit firms websites the information on responsibilities can be read. This would help focus attention on more company-specific audit information.

Question 15

What are your views on whether the IAASB's suggested structure of the illustrative report, including placement of the auditor's opinion and the Auditor Commentary section towards the beginning of the report, gives appropriate emphasis to matters of most importance to users?

ICGN does not consider a change in the structure of the audit report to be very important. We believe that strengthening the audit report's content through the inclusion of more entity-specific information (statements on going concern, audit commentary) based on the audit work and findings, is more vital for institutional investors than mandating the precise ordering of the elements on a global scale.

Question 16

What are your views regarding the need for global consistency in auditors' reports when ISAs, or national auditing standards that incorporate or are otherwise based on ISAs, are used?

IAASB rightly identifies that various models exist for audit reporting driven by various socio-economic, legal and cultural factors. ICGN believes IAASB is right in trying to find the right balance in the need for global consistency and comparability and the need to increase the value of the audit reporting by including flexibility to accommodate national circumstances. The suggested building block approach offers an appropriate concept to achieve this crucial balance.

If you would like to discuss any of these points, please do not hesitate to contact Kerrie Waring, ICGN Chief Operating Officer, at +44 207 612 7079 or kerrie.waring@icgn.org. Thank you for your attention and we look forward to your response on the points above.

Yours sincerely,



Janine M. Guillot
Co-Chair, ICGN Accounting and
Auditing Practices Committee



Elizabeth Murrall
Co-Chair, ICGN Accounting and
Auditing Practices Committee



Michelle Edkins
Chairman of the ICGN Board of Governors

Cc: ICGN Board Members
ICGN AAPC