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Mr. James Gunn
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

RE: IAASB Invitation to Comment, Improving the Auditor's Report

Dear Mr. Gunn,

BDO International Limited¹ (BDO) is pleased to have the opportunity to comment on the International Auditing and Assurance Standards Board's (IAASB or Board) Invitation to Comment (ITC), *Improving the Auditor's Report*. We are committed to enhancing the communicative value of financial reporting and, in particular, the value of the auditor's report. In that regard, we support the goals of the IAASB's initiative and are open to exploring a range of possible changes to meet those goals. Moreover, we are committed to participating in the dialogue to effect responsible and meaningful change that will enable users to obtain further insights into the nature, risks, and complexities of the financial statements.

To further that dialogue, where our views differ from those proposed in the ITC, we have suggested alternatives that we believe address the objectives of user calls for additional information about the financial statements to assist them in making informed decisions and understanding the distinction between the auditor's role and professional responsibilities in the financial reporting process and those of management. For example, with respect to providing additional information to users, we suggest several alternatives for consideration by the Board, including:

1. the use of an expanded emphasis of matter (EOM) paragraph that would draw users' attention to those areas in the financial statements and disclosures that in the auditor's judgment are likely to be most important to users' understanding of the financial statements;
2. a tiered approach for providing earlier warnings about matters that raise liquidity concerns, based on an enhanced financial reporting disclosure requirement for management and subsequent auditor reporting; and
3. expanding the description of the auditor's responsibility to include the requirement for the auditor's report to refer to any material inconsistencies between the other information and the financial statements, and to any material misstatements in the other information.

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We also support co-ordination of the IAASB's efforts with other participants in the financial reporting supply chain, such as accounting standard setters, regulators, financial statement preparers, and those charged with governance (TCWG). For example, changes are needed to explain more clearly and succinctly the sensitivity and risks associated with complex and/or highly judgmental business transactions.

Additionally, we encourage the IAASB to monitor developments relating to improvements in financial statement disclosures being considered by the European Financial Reporting Advisory Group, the Financial Reporting Council of the United Kingdom, the U.S. Financial Accounting Standards Board, and the Autorite Des Normes Comptables of France. We believe that coordinating efforts with these organizations, to inform users about the matters most important to their understanding of the financial statements based on defined criteria, would significantly enhance the effectiveness of such information.

The details of our alternative suggestions, as well as our views on other aspects of the ITC, are provided below in response to the specific questions posed. In certain instances, our comments appear after a grouping of related questions.

Our comments have been developed in consultation with our member firms and represent the collective view of our international organization. They are consistent with the following overarching principles previously outlined in our response to the IAASB Consultation Paper - *Enhancing the Value of Auditor Reporting: Exploring Options for Change*:

- 1) Management and/or TCWG (e.g. the audit committee), rather than the auditor, should be the original source of information about the entity;
- 2) Auditor reporting should focus on objective matters;
- 3) Changes should not detract from audit quality; and
- 4) Changes should enhance transparency in a way that does not promote information overload.

Overall Considerations

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?

We support the objectives of the ITC to provide enhanced information to users of the financial statements to increase their understanding of the audit process and the financial statements, as well as the distinct responsibilities of auditors and management.

While we support the objective of the auditor reporting project to "appropriately enhance the communicative value and relevance of the auditor's report," and support certain of the suggested improvements set out in the ITC, we have offered alternatives to other of the proposed suggestions that we believe more appropriately meet the needs of users, while respecting the distinctive roles of management, TCWG, and auditors in the financial reporting process.

2. Are there other alternatives to improve the auditor's report, or auditor reporting more broadly, that should be further considered by the IAASB, either alone or in coordination with others? Please explain your answer.

As noted above, we support an alternative approach to the Auditor Commentary (AC) as suggested in the ITC, and in that regard, we recommend using an expanded EOM paragraph to help the users

navigate through the financial statements and highlight the matters likely to be of most importance to their overall understanding of the financial statements. A detailed description of our recommendation is provided in response to questions 3-7 below.

As noted in the introduction, we have also suggested alternatives to improve the disclosures regarding the auditor's responsibility for other information and have proposed a way forward to providing users with more timely and transparent information regarding the entity's liquidity issues, including its ability to continue as a going concern. These suggested alternative approaches are described in response to questions 8 - 10.

Auditor Commentary (Questions 3 through 7)

- 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?**
- 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?**
- 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?**
- 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?**

As mentioned above, we support the use of an expanded EOM paragraph to achieve the same objective as the AC contemplated by the ITC, while avoiding its disadvantages. We believe such an approach will help users navigate the increasingly complex and lengthy disclosures within the financial statements by referencing those disclosures the auditor considered most important to the users' understanding, while respecting the distinct roles of the auditor and management. This EOM approach would constitute a brief factual description of the matter based on information already reported by management in the financial statements, and a reference to where that information is disclosed.

We recommend a two phased filter for deciding which items to include in an EOM paragraph. The auditor would first determine which aspects of the financial statements might warrant highlighting to improve users' understanding (e.g., unusual transactions, significant related party transactions, highly sensitive assumptions underlying estimates, complex accounting judgments, and material risks and uncertainties). The potential items would then be refined in the second phase of this approach to determine which items are likely to be the most important to the users' understanding of the financial statements. The criteria to be considered in this second phase could include filters such as whether the item was discussed with TCWG, whether the item was controversial, and if significant audit work was performed in the area. Such an approach would reduce the risk that too many items are emphasized, thus reducing the chance of diluting the effectiveness of the EOM paragraph. We would expect that under this approach, there would be an EOM paragraph in the auditor's report on substantially all audits where its use would need to be considered by the ultimate standard (see our response to question 7).

To avoid overreliance on the auditor's references to those areas of most importance, we recommend that the auditor's report include a paragraph explaining that the matters emphasized

were based on the auditor's professional judgment and that others' views may differ. For this reason it is important for the auditor's report to emphasize that the EOM paragraph be read in conjunction with the financial statements, including the footnote disclosures, taken as a whole.

While we appreciate the rationale behind users' calls for more transparent information about the audit, we do not support the nature of the AC contemplated by the ITC as the approach to meet that objective for the following reasons:

- a. The AC approach is inconsistent with certain of the overarching principles described in our introductory comments.
- b. There are many audit-related matters that are highly subjective and cannot be explained succinctly. Excessive information could obfuscate rather than clarify meaningful information to financial statement users. Accordingly, these matters are typically discussed between the auditor and management and/or TCWG in the context of a dialogue where all of the relevant considerations can be explored in the proper context. These effective dialogues assist TCWG with understanding the audit risks and matters that may be contentious. In contrast, any additional audit-related information included in the auditor's report is unlikely to be understood by other users who do not possess a comprehensive knowledge of the attendant facts and circumstances.

We considered the experiences of users with respect to the requirement in France for the statutory auditor's report to include a "justification of assessments." This requires the auditor to explain his or her audit procedures, while not disclosing information that the entity itself has properly not disclosed. The French National Institute of Statutory Auditors engaged an external consultant (Footprint>Consultants) to conduct a study to examine the perceptions of the justification of assessments by financial statement users. The study pointed to the benefit of the justification as a means to draw attention to highly sensitive items - thereby acting as a compass for navigating the financial statements, which are otherwise difficult to read. This correlates with the primary objective of the EOM approach we support. However, the study also found that some interviewees were critical of the potential for so-called laundry lists of audit procedures related to the areas covered by the assessments. In addition, users generally felt that over the past five years, the wording of the disclosures has tended to become more sterile and standardized, reducing its usefulness. We are concerned that these findings would also likely be evident if audit procedures were discussed in an AC.

- c. It is possible that disclosures in the AC would differ in some respects from those of management elsewhere in the document, which may create confusion and/or the impression that the different views represent a qualified opinion.
- d. There may be unintended consequences of disclosing sensitive information about the entity that may limit the robustness and candor of discussions between the auditor and management and/or TCWG. Such candid discussions are essential for the auditor to understand the entity and its financial information and are critical to properly assess risks and, therefore, to preserve the quality of the audit.
- e. The AC approach, in contrast to our recommended EOM approach, would require significant additional auditor effort to prepare and additional time for quality control review and approvals within the audit firm, resulting in potential delays in filings.

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?

If the ultimate standard uses the concept of the AC or our recommended expanded EOM approach, we recommend the changes be phased in. The changes should be first implemented by PIE's (more specifically for listed entities above a certain market capitalization), with cost/benefit studies performed prior to requiring any implementation to a broader group of PIEs. Users of the financial statements of PIEs are more likely to demand some sort of AC, in contrast to users of privately-held entities (e.g., owners of closely-held entities and lenders), who can generally obtain additional information about the entity through other means.

In addition, we do not think it would be appropriate at this time to include public sector entities in the definition of PIEs for this purpose since many are small and do not appear to be the primary source of demands for AC. In any event, we support the IAASB's continued dialogue with the INTOSAI in this regard.

Going Concern (Questions 8 and 9)

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?
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?

The recent financial crisis highlighted the importance of more timely warnings of impending financial distress. The call for accelerated warnings has come from a variety of groups around the world, including the U.K. Sharman Panel of Inquiry, which issued its report in June 2012. In that regard, we believe that the current threshold for disclosure of financial distress is too high. Not only does the going concern warning under the current binary model carry with it a significant stigma, but it also may come too late in a company's downward spiral to promote timely, meaningful communication. A suitably lower threshold for highlighting these concerns would provide greater context and transparency into the liquidity risks facing a company and could reduce the element of surprise attendant with the dramatic going concern EOM paragraph.

We still believe that the auditor's report should continue to include a red flag signaling a material uncertainty that casts significant doubt regarding a company's viability and believe that a clear warning at that level of severity is still necessary (as do many respondents to the Sharman Panel's Preliminary Report issued in 2011). Accordingly, we recommend a two-tiered approach, involving management and the auditors. Under this approach, management would have the primary responsibility for relevant disclosures of financial difficulties based on financial reporting disclosure standards that would need to be developed, and auditor reports would cover these disclosures.

The first step in this tiered approach would be for management to disclose whether the financial statements appropriately reflect a going concern assumption. This should not be a difficult disclosure since there is already an extremely high hurdle under IAS 1 for a liquidation basis of preparation (applicable when management either intends to liquidate the company or has no other realistic alternative).

The second tier would be triggered if management, applying reasonable business judgment, is aware of conditions or events that indicate, based on current facts and circumstances that it is reasonably foreseeable that a company would have liquidity issues without resorting to special remedies, such as renegotiating its debt, raising capital, or unusual asset disposals. This threshold would need to be clearly defined so that it is wide enough to capture truly significant disclosures, but is not so wide as to dilute any meaningful disclosures. If this threshold is met, management would qualitatively disclose the underlying circumstances, their processes for identifying relevant conditions, their plans for dealing with them, and the potential implications if the plans were not effective. Management should be given adequate flexibility to determine the nature of its disclosures, which should vary based on the severity of the underlying conditions. Management would also disclose if this new threshold is not met, so there would be an explicit statement that there is nothing to report.

When the continuum of risks meets a higher threshold, such as “probable,” it would trigger management’s use of the “significant doubt” language similar to that of IAS 1. A clear and operational definition of this threshold would need to be developed.

We then suggest that the auditor’s report refer to management’s disclosure in an EOM paragraph, which would reference the footnote disclosure and mirror the substance of the severity of the conditions.

The Need for Financial Reporting Disclosure Standards

The core element of this tiered approach is development of clear and robust financial reporting disclosure standards. Currently, there are no specific standards to guide management in developing going concern disclosures. IAS 1 broadly requires disclosure of material uncertainties related to events or conditions that may cast significant going concern doubt. But the focus of IAS 1 is on whether the going concern assumption is appropriate, not about what constitutes a material uncertainty or significant doubt, or what disclosures are appropriate in the circumstances.

ISA 570 requires disclosure in the auditor’s report of material uncertainties related to going concern when it is necessary for a fair presentation of the financial statements. It also provides substantial guidance for the auditors in assessing going concern. However, we believe that this type of guidance is better placed in the financial reporting standards. Accordingly, we urge the IAASB to work closely with the IASB and other standard setters in arriving at a common framework that can be used by both preparers and auditors in driving consistent assessment and disclosure of financial distress. This would apply not only to assessments of whether material uncertainties cast significant doubt, as in the current standards, but also to situations where a lower, but still meaningful, risk threshold is met.

In addition, given the judgment needed to determine the types of events that need to be considered during the assessment by management and auditors, we believe the enhanced financial reporting standards should contain examples of situations that do or do not, create reportable concerns under the tiered model proposed above.

Under this tiered approach, the auditors would evaluate management’s disclosures by performing certain audit procedures, rather than providing their own incremental disclosures in their report.

As mentioned above, we believe the approach where management provides robust and meaningful disclosures that would be covered by the auditor’s report is a fundamental principle that preserves the historic responsibilities of both parties and avoids sending potentially confusing messages to financial statement users.

Time Period Covered

A key element in the going concern evaluation is the time period involved in the assessment. The auditing standard criterion of at least twelve months from the balance sheet date has existed for years. While this appears open-ended, we understand that it is generally interpreted in practice as applying to known information about events for a relatively short period beyond the twelve month time frame. So, considering the influence that IAASB and IASB standards may have on other standards setters and recognizing that the ability to assess uncertainties decreases with the length of the assessment period, we believe there should be guidance in the standards for determining the appropriate future assessment period.

Clarification of the time period should also give appropriate recognition to the legal regimes in various jurisdictions that might view the current open-ended time period inconsistently, resulting in unpredictable exposure to liability. An appropriate clarification of the time period intended to be covered, as well as the suggested language in the ITC that an auditor's conclusion as to going concern is not a guarantee, should mitigate the need for a regulatory safe harbor that might otherwise be warranted with respect to the forward-looking nature of this conclusion.

Placement of Disclosures

We realize there are various financial reporting and regulatory frameworks around the world that differ in their requirements to disclose risks and uncertainties, including those that may ultimately cast significant doubt on the going concern assumption. Many of these disclosures appear outside of the financial statements because of the significant judgments necessary and to provide maximum flexibility in management's narrative. We believe it would promote consistency in disclosures and comprehension if matters relating to the analysis of financial distress appeared, to the extent practicable, in one place in the notes to the financial statements.

Auditor Reporting

We have no objection to inclusion in the auditor's report of the statement that addresses the appropriateness of the going concern assumption. The threshold for that assumption is quite clear. However, if such a statement by management is ultimately required by a new financial reporting standard, there would be no need for the auditor to state it explicitly.

With respect to the auditor stating whether material uncertainties have been identified, we believe our suggested tiered approach to financial reporting disclosure along a continuum of severity, and the corresponding EOM paragraph that refers to those disclosures, would inherently indicate that the auditors are satisfied with them. If such disclosures are not satisfactory, the auditors would address the deficiency in their report. Under this scenario, there would be no need for a specific statement by the auditors about whether or not material uncertainties have been identified. Nevertheless, we recognize that such a statement is consistent with the European Commission's proposed regulation concerning auditor reporting for PIEs. In that regard, we suggest that the IAASB consider any legal implications of providing an explicit statement as suggested by the ITC.

Other Information

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

We support the inclusion of a statement in the report on the auditor's responsibilities for other information since it would clarify the nature and extent of work performed and help avoid misunderstandings. We suggest that the statement be placed after the illustrative section dealing with the auditor's responsibilities for the audit, since it is not directly related to the audit of the financial statements.

While we support clarifying the auditor's responsibility for other information, we are concerned about the inclusion of a conclusion as to whether any material inconsistencies were identified. This appears to be a form of negative assurance that, in our view, should only be provided when there are meaningful procedures performed (e.g., on a review engagement). We do not believe that a mere reading of the other information constitutes sufficient work to include a negative assurance statement on it in the auditor's report.

We do, however, understand that some jurisdictions (for example the U.K. and South Africa) already have this type of negative assurance included in their auditor's report. That may be appropriate in these particular circumstances. Nevertheless, we believe the objective of an explicit conclusion can be achieved another way. The separate section in the auditor's report can describe the auditor's existing responsibilities with respect to inconsistencies or misstatements and go on to explain what the ISA requires the auditor to do if an inconsistency or misstatement is identified, including disclosure of the matter in the auditor's report if it is not resolved. The absence of any such disclosure of identified matters would constitute an implicit conclusion on the other information.

Regardless of the approach taken, we agree with the inclusion of the statement in the illustrative auditor's report that the auditor did not audit the other information and does not express an opinion on it.

We do not necessarily agree with the rationale expressed in the ITC for excluding material misstatements of fact from the discussion of the auditor's responsibility for other information. This responsibility is part of ISA 720 - *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* and should be communicated as such. Furthermore, while we agree that it would not be appropriate to state a conclusion with respect to absence of material misstatements of fact because of the insufficient work effort involved, the same rationale might also apply to material inconsistencies involving qualitative matters that may not be identified through a mere reading of the other information.

Clarifications and Transparency (Questions 11 through 14)

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?

We agree that the enhanced descriptions of responsibilities will help to narrow the expectation gap and agree with the suggested descriptions included in the sample report.

12. What are your views on the value and impediments of disclosing the name of the engagement partner?

We do not believe the inclusion of the partner's name in the auditor's report would improve audit quality by increasing personal accountability in a meaningful way. There is already sufficient pressure applied through current oversight of the audit through partner accountability to multiple external parties, including regulators, investors, and TCWG, in addition to those within the audit firm. We recognize that some jurisdictions currently require the personal signature and name of the engagement partner in the audit report. However, the legal environments in those jurisdictions may not be the same as others. Therefore, we recommend that the IAASB leave the decision as to this disclosure to the local jurisdiction.

13. What are your views on the value and impediments of the suggested disclosure regarding the involvement of other auditors? Do you believe that such a disclosure should be included in all relevant circumstances, or left to the auditor's judgment as part of Auditor Commentary?

While we support consideration by the IAASB of whether disclosure of other auditor involvement should be required, we are concerned that such disclosure seems to undermine the overall accountability of the group engagement partner, which is contradictory to ISA 600 - *Special Considerations - Audits of Group Financial Statements* and, to some extent, with the proposed inclusion of the engagement partner's name on the audit report.

However, we do support a description in the Auditor's Responsibility section of the auditors' responsibilities in a group audit situation.

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?

We believe it would be appropriate to present this information outside of the auditor's report (and reference made in the report to where the information could be found). It could generally be made accessible on a regulatory or professional body website for users to access. Where the auditor believes the users would not refer to a website, a reference could be made to an appendix where the responsibilities could be described.

Form and Structure (Questions 15 through 18)

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?

Overall, we agree with the notion that "an audit is an audit", and believe all reports should have the same or substantially similar requirements. However, see our response to question 7 with respect to AC.

We agree with the suggested placement of the auditor's opinion at the beginning of the report to emphasize its importance to users and also agree that an EOM paragraph (or AC) be placed near the beginning of the report for prominence.

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?
17. What are your views as to whether the IAASB should mandate the ordering of items in a manner similar to that shown in the illustrative report, unless law or regulation require otherwise? Would this provide sufficient flexibility to accommodate national reporting requirements or practices?

We agree with striving for consistency in order to help users compare the nature of the auditor's report across similar entities, and we believe the standard should strongly encourage (but not necessarily mandate) placement of paragraphs within the report, leaving ultimate placement up to jurisdictions or national auditing standard setters. The use of titles will also assist users if paragraphs are in fact different from those in the ultimate standard.

18. In your view, are the IAASB's suggested improvements appropriate for entities of all sizes and in both the public and private sectors? What considerations specific to audits of small-and medium-sized entities (SMEs) and public sector entities should the IAASB further take into account in approaching its standard-setting proposals?

The suggested improvements could generally be applied by all companies upon adoption of the new standard, except for the EOM paragraph or AC (see our response to question 7).

We reiterate our strong support of the Board's initiative to improve the communicative value of the auditor's report. In that regard, we encourage the Board to promote a collaborative approach with other participants in the financial reporting supply chain. Given the interrelationships among these participants, and their roles in communicating meaningful and valuable financial information, such a holistic approach is essential to achieve the objectives of the ITC. BDO is pleased to participate in this process.

Finally, in deliberating any potential expansion of financial statement and auditor reporting, we believe there should be adequate field testing by participants in the financial reporting process to ensure that the needs of financial statement users are met and that there are no unintended consequences.

Please contact me should you wish to discuss any of these comments.

Yours sincerely,
BDO International Limited

Wayne Kolins
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