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22 November 2013

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

RE: IAASB Exposure Draft – Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)

Dear Mr. Gunn,

BDO International Limited[1] (BDO) is pleased to have the opportunity to respond to the International Auditing and Assurance Standards Board's (IAASB or Board) Exposure Draft, *Reporting on Audited Financial Statements* (ED or proposal).

We remain supportive of the Board's goal of improving the communicative value of the auditor's report, in recognition of the significant demand for change from users of financial statements and the need for greater clarity about what an audit represents. In our view, the ED is a substantial step forward in the journey to bring about responsible and meaningful change that will better enable users to obtain further insights into the risk-based nature of audits.

While there are certain elements of the ED where we have raised issues in this letter, we have suggested alternatives in appropriate circumstances intended to address user needs. In particular, we suggest a tiered approach for providing earlier warnings about matters that raise liquidity concerns, based on an enhanced financial reporting disclosure framework for management and related auditor reporting. We appreciate the IAASB's active liaison with the IASB and FASB in connection with their going concern projects. We agree that a holistic approach that harmonizes financial reporting and audit reporting is essential to communication of meaningful and transparent information to users.

The PCAOB's current proposal on Auditor Reporting is broadly similar to the ED with respect to key audit matters (KAM), while differing in certain detailed respects. In furtherance of a harmonized approach to reporting, particularly given the increasing globalization of the business community, we recommend that the IAASB and PCAOB work to align their standards to the fullest extent possible.

We also suggest that the Board consider the challenges and usefulness of the KAM for listed companies under a certain size. In that regard, the PCAOB proposal would exempt emerging growth companies, subject to a separate determination by the SEC. The Board could

[1] BDO International Limited is a UK company limited by guarantee. It is the governing entity of the international BDO network of independent member firms ('the BDO network'). Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.

formulate a similar type of exemption, with the details to be established within each country's regulatory environment.

The portion of proposed ISA 701 dealing with KAM would represent the most dramatic change in practice for auditors. Accordingly, we agree that field testing of this element is essential to understand its consequences. While retrospective field testing of 2012 audits would provide some benefit, it would not sufficiently enable auditors to assess how the reporting of KAM would operate in live situations, reflecting actual engagement circumstances, such as (1) the effect disclosure of certain risks may have on the robustness and candor of discussions between the auditors and those charged with governance, (2) how the audit firm's review protocols were able to deal with determining the adequacy of disclosures, and (3) the effect on the timing of filings. In that regard, there is perhaps a more effective approach that can be used as a supplement to retrospective field testing. The UK's Financial Reporting Council (FRC) recently issued ISA (UK and Ireland) 700 - *The Independent Auditor's Report on Financial Statements.* This standard requires the auditor's report on entities that report on how they have applied the UK Corporate Governance Code to: (1) describe the risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall strategy, the allocation of resources on the audit, and directing the effects of the engagement team and (2) provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risk of material misstatement. While the FRC standard goes beyond proposed ISA 701 by requiring disclosure of the audit scope addressing risks of material misstatement, the examples in the ED reflect this type of disclosure even though it is not required unless the auditor considers it necessary.

To date, we are aware of only a small number of reports that have been issued under the new FRC standard (effective for years beginning on or after 1 October 2012). However, with the bulk of entities covered by the new standard having calendar year ends, there should be a substantial population with which to perform a thorough analysis of the consequences of the standard even though there are differences between that part of the FRC standard and the KAM section of the ED. Based on this opportunity and given the experimental nature and early stage of evolution of the KAM, we recommend extension of the comment period on the ED to a reasonable date in 2014 when such analysis can be completed and communicated to the financial reporting community.

While we are supportive of an expansion of the auditor's reporting obligation, there also needs to be an assessment of whether, and if so how, the expanded reporting might affect the auditor's liability in various jurisdictions. In that regard, a potential adverse consequence of litigation risk arising from the new audit report could be boilerplate disclosures. Accordingly, the Board should evaluate steps it can take to modify the proposal to mitigate any such liability.

The details of our aforementioned suggestions, as well as our views on other aspects of the ED, are provided below in response to the specific questions posed.

Key Audit Matters

1. **Do users of the audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?**

   While we are responding as auditors, we recognize, based on IAASB research, that users are demanding additional insights into the audit and believe that the introduction of the new section will enhance the usefulness of the auditor's report.

2. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor's judgment in determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?**

   We agree that the framework is generally appropriate to guide the auditor's judgment in determining which matters should be disclosed as KAM in the auditor's report. However, we suggest moving to paragraph 10 the application guidance in paragraph A37 that the auditor should avoid descriptions of KAM that inappropriately provide original information about the entity that is the responsibility of management and those charged with governance unless, in in the auditor's judgment, the information is critical to the KAM analysis. This is a fundamental principle of KAM disclosures and should be highlighted as such.

   While application of proposed ISA 701 provides a reasonable filter for auditor judgments, given the entity-specific nature of the required disclosures and the differing perspectives of the auditors in any particular situation, there will always be some reasonable variation in applying such judgments. However, the filters provided by the proposal appear to be a useful approach to achieve reasonable consistency.

   In addition, we believe that consistency in making such judgments on audits of multi-nationals will be improved if the IAASB and PCAOB align their different criteria for determining suitable disclosures.

3. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor's report? If not, why?**

   We believe that, with the exception noted below, the proposed requirements and application material generally provide auditors with sufficient direction to determine what to include in the descriptions of KAM and appropriately allow auditors to use their judgment. We would caution, though, that providing too many examples could lead to them becoming overly prescriptive, leading to boilerplate disclosures over time. Given the evolutionary stage of these disclosures, we expect best practices to emerge, reflecting entity-specific judgments, industry factors, and user demands.

   In our view, the provisions in paragraph 10(a) lack sufficient clarity. They call for disclosure of the effect of the KAM on the audit 'to the extent the auditor considers it necessary'. This would seem to provide for such reporting on an exception basis. In contrast, three of the four examples contain such disclosures. If users require a brief overview of the audit procedures in response to KAM, we support mandating such disclosure only after a suitable period of experimentation resulting in satisfactory feedback. Pending the outcome of the experimentation, we suggest that such disclosures be voluntary. Care should be taken, though, to avoid lengthy discourse of audit procedures since this could obfuscate important disclosures and be difficult to understand without a full background of the attendant circumstances.

   We agree with the statement in paragraph A37 that auditors should avoid descriptions of KAM that inappropriately provide original information about the entity that is the responsibility of management and TCWG unless, in the auditor's judgment, the information is critical to the KAM analysis. We feel that this is a reasonable approach provided auditors apply it judiciously. However, we hope that any such disclosures would not become the norm; otherwise, this scenario could be perceived as the auditors taking primary responsibility for footnote and other disclosures in the financial statements to the extent that management feels compelled to amend their disclosures in the document to conform with those of the auditor.

We have a particular concern with potential disclosure of significant deficiencies in internal control as an indicator of a KAM, as described in paragraph A23. While we appreciate the related guidance in paragraphs A36 and A37 regarding the original information nature of any such disclosure and the care to be taken in describing such matters in the KAM section, it is not clear to us how this can be achieved without divulging the significant deficiency and characterizing it as such. Moreover, if it is expected that significant deficiencies would be disclosed in some manner, this could create the perception that the absence of such disclosures in the auditor's report is an implicit positive opinion of the effectiveness of internal controls.

We have difficulty in agreeing with the option in paragraph A38 of including an indication of the outcome of the auditing procedures. This appears to be substantially the same as a piecemeal opinion, which undercuts the focus on the financial statements taken as a whole, notwithstanding the caveat in the introductory language that states that the auditor does not express an opinion on individual matters (see also paragraph A41).

4. **Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking in informational value, and why? Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.**

The examples vary in the information value they provide. To the extent users want information regarding the specific nature of significant audit risks, we believe the examples relating to Goodwill and Valuation of Financial Instruments are better than the other two. The example for the Acquisition of XYZ Business does not include an overview of relevant audit procedures to address the risks and, therefore, may not satisfy the demands of some users (see our response to Question 3). While the Revenue Recognition example includes an overview of relevant audit procedures, there seems to be an excessive focus on fraud and side agreements compared to the risks involved in assessing the amount and timing of revenue recognition. In addition, the example relating to Valuation of Financial Instruments and Revenue Recognition contain conclusions on elements of the topics based on the audit procedures described. This may imply a piecemeal opinion, as articulated in our response to Question 3. Any such implication should be avoided.

5. **Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why? Are there other practical considerations that may affect the auditor's ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?**

We agree that auditors who voluntarily communicate KAM in their report be required to follow ISA 701 and that the auditor must signal this intent in the audit engagement letter. This will promote consistency in reporting and help to avoid confusion in the marketplace.

6. **Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate?**

   (a) **If so, do respondents agree with the proposed requirements addressing such circumstances?**

   (b) **If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor's responsibilities under proposed ISA 701 and the determination, in the auditor's professional judgment, that there are no key audit matters to communicate?**

   We believe that it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no KAM to communicate. In addition, we agree with the proposed requirements addressing such circumstances and with the application guidance in paragraph A47 indicating that this situation would be expected to be rare.

7. **Do respondents agree that, when comparative financial information is presented, the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?**

   We agree that the communication of KAM should be limited to the audit of the most recent period due to the practical challenges listed in paragraph 65.

   We recommend that the explanation in application guidance paragraph A9 be expanded to provide additional guidance to allow for comments regarding changes in KAM compared to the prior year to be included in the auditor's report in the rare circumstance where the auditor believes it would be beneficial to users. However, we also favor the guidance in the related PCAOB proposal (paragraphs 10 and A1-8) that states *'…the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.'*

8. **Do respondents agree with the IAASB's decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters, and how such concepts have been differentiated in the Proposed ISAs? If not, why?**

   We agree with the IAASB's decision to retain the concepts of the Emphasis of Matter and Other Matter paragraphs for the reasons stated in paragraphs 74-79 of the Explanatory Memorandum. We also agree with how the concepts have been differentiated.

Going Concern

9. Do respondents agree with the statements included in the illustrative auditor's reports relating to:

(a) The appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements?

(b) Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to [continue as a going] concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised)?

In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.

As we stated in our response to the IAASB Invitation to Comment, *Improving the Auditor's Report*, 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 a dramatic going concern paragraph. The call for accelerated warnings has come from a variety of groups around the world, including the UK Sharman Panel of Inquiry, which issued its report in June 2012.

We still believe that the auditor's report should continue to have the potential to include a red flag signalling any 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. 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 realistic alternative). We note that the corporate governance requirements of certain jurisdictions require management to make a statement about going concern, including at a high level how they have concluded that the going concern assumption is appropriate.

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 increase in extent and depth 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, substantially mirroring 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 relating to going concern matters. 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.

The IASB and FASB have projects dealing with going concern, but the approaches currently being considered by them are not aligned with each other, or with the limited approach taken in the ED.

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.

We urge the IAASB to continue 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 users.

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 paragraph in the auditor's report 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.

We also suggest that the IAASB consider any legal implications of providing an explicit statement as suggested by the ED.

10. What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?

While we agree with the objective behind such disclosure, we question whether the language as to no guarantee may convey to users an overly negative impression about the entity. In addition, this explicit statement does not distinguish between the responsibilities of the auditor and of management (who have primary responsibility for the financial statements). We suggest that the Board consider use of a different warning, such as:

> *The assumptions underlying the going concern statement may change based on future circumstances and, accordingly, may affect the entity's ability to continue as a going concern.*

Compliance with Independence and Other Relevant Ethical Requirements

11. What are respondents' views as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?

We agree with the requirement to disclose the source(s) of independence and other ethical requirements in the auditor's report. In that regard, we suggest that those disclosures refer to the national requirements of the entity's auditor as well as the IFAC Code of Ethics. With respect to group audits, we believe that only the requirements applicable to the group auditor need disclosure. If any of the component auditors' rules are less stringent, they will still be required to meet the requirement of the group auditor; if they are more stringent, they would not be disclosed in order to avoid unduly complex and lengthy disclosures that may lack value to users and create confusion. As such, we recommend that paragraph A29 of the proposed ISA 700 application guidance clarify that ordinarily the requirement to disclose the independence and ethical rules apply only to the group auditor.

Disclosure of the Name of the Engagement Partner

12. What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?

We do not believe the inclusion of the partner's name in the auditor's report will improve audit quality by increasing personal accountability in a meaningful way. We understand that users are generally requesting this information; however, there are other mechanisms available to listed companies for disclosing the partner's name. We recognise that some jurisdictions currently require a personal signature and name of the engagement partner on the audit report; however we believe that due to the differences in legal environments, the ultimate decision on disclosure should be left to the local jurisdiction.

We agree with the 'harm's way exemption,' recognizing that it would be rare.

13. What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?

We believe that the proposed requirements relating to the inclusion of the auditor's responsibilities for the audit and the application guidance highlighting the options are clear. We agree there are benefits to including the responsibilities in the report, in an appendix, or referenced to an authoritative website depending on the nature and circumstances of the client and user needs.

We agree with allowing auditors to disclose other reporting responsibilities in the auditor's report and ensuring that the responsibilities are clearly differentiated from the ISA reporting requirements.

14. What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20-45 and the circumstances addressed in paragraphs 46-48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?

We agree with striving for consistency in the layout of the auditor's report without mandating the ordering of sections. We believe this can be achieved through consistency of paragraph placement in sample reports issued by the IAASB and national standard setters, and the use of paragraph headings or titles to guide users. However, we do believe that the audit opinion should be the first section in all cases because of its primary importance to users.

In addition, we believe the level of prescription in the aforementioned paragraphs is appropriate in the circumstances.

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We appreciate the opportunity to comment on the ED and reiterate our support for the Board's commitment to improve the communicative value of the auditor's report. In that regard, as articulated earlier in our letter, we recommend a suitable extension of the comment period to use the opportunity provided by implementation of the recently issued FRC standard with respect to expanded auditor reporting to assess the related benefits and consequences. This 'live field test', supplemented by retrospective field tests using the ED, will hopefully produce sufficient information to allay operational concerns and craft final standards that are appropriate in the circumstances and meet the needs of users.

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

Yours sincerely,
BDO International Limited

Wayne Kolins
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