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IAASB ED– Reporting on Audited Financial Statements

Dear Professor Schilder, *BERNIE ARNOLD,*

The European Securities and Markets Authority (ESMA) has considered the Exposure Draft (ED) *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* and thanks you for the opportunity to contribute to the IAASB's due process. ESMA appreciates the IAASB's efforts to explore ways to improve auditor reporting in order to enhance the communicative value of the auditor's report by providing more transparency on the audit work performed. The views expressed in this letter are made from the point of view of securities regulators with the aim to enhance investors' protection and with an interest in the quality of listed entities' auditors' reports.

ESMA believes that the proposed auditor's report should bring a higher degree of transparency to the audit process, thus contributing to increased responsibility for and enhanced accountability of the auditor. The suggested auditor's report includes key audit matters and should enable a better understanding of the auditor's work efforts and of the key judgements and conclusions relevant to a specific audit.

ESMA supports the general direction of the proposed changes. However, we are concerned that the proposed standards do not provide clear requirements and sufficient guidance to guarantee consistency in the auditors' approach to key audit matters. Efforts should be undertaken to avoid as much as possible situations where auditor's reports are different despite very similar circumstances in practice. This would raise confusion for the users rather than being of help for their understanding of the audit and create difficulties in relation to enforceability of requirements.



ESMA also believes that items included in the Key Audit Matters section should be made unique and as specific to the audit of the entity as possible and should not contain boilerplate language.

Consistent with ESMA's comment letter¹ to the IAASB's Invitation to Comment – *Improving the Auditor's Report* we would like to re-emphasize that the auditor's reporting on going concern is of crucial importance for users. While supporting the explicit reference to the assessment of going concern, further consideration should be given to a more entity specific going concern assessment in the auditor's report. ESMA would also encourage the IAASB to work further on this issue in close cooperation with the International Accounting Standard Board (IASB) and provide more detailed guidance on the concept of going concern.

ESMA encourages the IAASB to consider the European Commission proposal for an amended directive on statutory audits and to consider the need to amend ISAs in that respect.

Our detailed comments on the specific questions asked in the ED are set out in the Appendix to this letter.

Please do not hesitate to contact us should you wish to discuss any of the issues we have raised.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S Maijoor', written over a horizontal line.

Steven Maijoor,
Chair

European Securities and Markets Authority

¹ 2012/ESMA/849 <http://www.esma.europa.eu/system/files/2012-849.pdf>

APPENDIX – ESMA’s detailed answers to the questions in the IAASB’s ED: *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*

Section: Key audit matters

Question 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?

Question 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?

Question 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?

Question 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.

1. ESMA acknowledges that the proposed ISA 701 – *Communicating Key Audit Matters in the Independent Auditor’s Report* focuses on communicating the key audit matters with the aim of enhancing users’ understanding of the audit work performed. We concur with the IAASB’s expectations that this approach could bring benefits in terms of increasing audit quality, increasing attention from the management and those charged with governance to the disclosures in the financial statements, and enhancing communication between auditors and those charged with governance.

2. The requirements in the proposed ISA 701 indicate that the key audit matters are selected from matters communicated with those charged with governance that, in the auditor's professional judgment, were of most significance in the audit of the financial statements. The requirements indicate a list of possible categories of key audit matters which is not exhaustive but clearly state that determining the key audit matters to communicate in the auditor's report and the sufficiency and appropriateness of their descriptions is a matter of professional judgement.
3. Without prejudice to the necessary and unavoidable use of professional judgement by auditors, ESMA believes that these requirements and related guidance should be improved in order to assist auditors to identify more precisely the key audit matters and the content of their description in the auditor's report. The definition of a key audit matter should be more prescriptive and the concept of "most significance" introduced in the new ISA 701 should also be defined and clarified. There is a need for more direction in the identification of what a key audit matter is, when it has to be disclosed and how to disclose it, in order to reduce auditor's discretion; this can also be done through more detailed guidance and examples.
4. ESMA is concerned that too much room for professional judgment in the determination and disclosure of the key audit matters would allow a large number of situations where auditor's reports will be different despite very similar circumstances in practice. Such situations would raise confusion for users, rather than being of help for their understanding of the audit and would create difficulties in relation to enforceability of requirements.
5. Therefore, ESMA believes that clearer requirements in the standard accompanied by more detailed guidance would ensure more consistency between the approaches of different auditors and benefit the users of their reports.
6. We would also suggest to bring some guidance into the requirements section, such as, for example, the guidance in paragraphs A25 and A34 which explain clearly that key audit matters are not a substitute for the auditor expressing a qualified opinion or an adverse opinion, nor a substitute for required disclosures in the financial statements. The same would apply for guidance to identify the threshold of "significance" (paragraphs A2 and A24), and for guidance on the content of the description in the auditor's report (paragraphs A31 and A38 to A41).

7. In our view there are three elements of information related to each key audit matter which should always be disclosed: (i) the nature of the audit matter; (ii) the audit approach adopted with respect to the matter; and (iii) the outcome of the auditor's work.
8. The objective of communicating key audit matters is not only to enhance users' understanding of the audit performed but also to assist them in understanding the entity and areas of significant management judgement. ESMA believes that in order to fulfil this objective key audit matters should be prescriptive and as entity-specific as possible. Auditors should focus on providing information that is specific to the entity and its audit and we encourage the IAASB to include these criteria in the requirements section. This should avoid the risk of generic descriptions and boilerplate language in the auditor's report.
9. ESMA would suggest considering whether or not circumstances reported to those charged with governance in relation to auditor' independence issues could be considered as a key audit matter or included in the *Other Matter* paragraph if relevant.
10. Regarding the need for including information about risk assessment and materiality, we recommend the IAASB to further engage with stakeholders and users of financial statements, as well as review experience of jurisdictions that have recently put in place disclosures in this area. We would also recommend taking into account the European Commission proposal for an amended directive on statutory audits and the need for flexibility in the proposed ISAs in order to accommodate potential legislative changes.

Illustrative examples

11. As regards the illustrative examples on key audit matters, ESMA acknowledges their usefulness and encourages the IAASB to provide more examples on the basis of different scenarios that would help to convey the right message on the use of key audit matters. However, we would like to highlight that the specific examples provided in the explanatory memorandum accompanying the proposed EDs reveal some inconsistencies in the approach used when describing the audit work done.
12. In the *Illustrative Auditor's Report*, the four examples under the key audit matters section seem to provide a different level of 'assurance': in the first and third example no conclusions are expressed on the basis of the work done, whereas in the second example there is a sort of positive statement as a conclusion, and in the fourth example there is a sort of negative assurance statement. The rationale for using different wording is unclear.

13. In addition, we believe that the examples should cover at least the range of key audit matters potentially identifiable in each of the areas and circumstances listed in paragraph 8 of the proposed ISA 701 and should be accompanied by a description of the context, including the audit work done and the disclosure provided in the financial statements, if any.

Question 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?

14. ESMA focuses on entities with listed securities on regulated markets and our comments are made in this context. Nonetheless we agree with the IAASB’s approach that key audit matters communicated on a voluntary basis should be in compliance with proposed ISA 701.

Question 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?

15. ESMA agrees with the fact there might be situations where the auditor determines that there are no key audit matters to be communicated and such a conclusion is presented in the auditor’s report. The rationale should however be documented in the working papers.

16. ESMA considers that additional guidance and examples could be provided to assist auditors to conclude that there are no key audit matters to be communicated.

Question 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?

17. ESMA understands the perceived usefulness of the idea that the determination of key audit matters should be limited to the current period, even if comparative financial information is presented. Nevertheless, it should be underlined in ISA 701 that a key audit matter in the previous period may continue to be a key audit matter in the audit of the current period, and additional guidance in this regard would be helpful especially in relation to ISA 510 – *Initial audit engagements*.

Question 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?

18. ESMA agrees with the decision to retain the concepts of Emphasis of Matter and Other Matters paragraphs, acknowledging that they are envisaged for areas which might not always be covered by the Key Audit Matters section.
19. However there could be situations of overlapping in which a matter covered in the Key Audit Matter section might also be relevant for the Emphasis of Matter and/or Other Matters paragraphs. We believe that interactions between proposed ISA 701 and proposed ISA 706 – *Emphasis of Matters Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report* are not clear and that there is a need of more specific criteria and guidance in the standards in order to differentiate these paragraphs and therefore to clarify the specificities and interactions among them.

20. As specified in the examples of auditor's reports, we note the need for aligning the content of the requirements on reporting on "Other information" with the prescriptions of the future standard ISA 720 – *The auditor's responsibilities relating to other information in documents containing audited financial statements*.

Section: Going concern

Question 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 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.

Question 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?

21. ESMA is in favour of a specific auditors' statement addressing the appropriateness of the management's use of the going concern assumption and identification of material uncertainties because we believe that an auditors' role in the assessment of the going concern assumption is important and should be emphasized.
22. However ESMA is concerned about the last sentence of the 'Going Concern' paragraph of the illustrated auditor's report – '*However, neither management nor the auditor can guarantee the Group's ability to continue as a going concern*' – which could lead to misunderstanding and raise doubts about the statements included immediately before, therefore we would rather avoid it.

23. Consistent with ESMA's comment letter to the IAASB Invitation to Comment, we would like to re-emphasize that ESMA is in favour of putting greater focus on the entity specific information in the going concern section that otherwise might become boilerplate and would decrease the value of such paragraph in the auditor's report for users.
24. ESMA would also support providing additional information by the auditor in case no material uncertainty exists, but certain events have been identified that may cast significant doubt on the entity's ability to continue as a going concern. Additional information regarding the auditor's assessment of the going concern assumption could reduce the expectation gap and information asymmetry between users and management of the entity. It might be helpful that the audit process undertaken in respect of the assessment of going concern is clearly described as part of the going concern section of the auditor's report.
25. We are aware that the issue of the disclosure of information regarding going concern is currently addressed both by the auditing and accounting professions at a global level. We commend the Board for its efforts to liaise with the IASB in this regard.

Section: Compliance with independence and Other Relevant Ethic Requirements

Question 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?

26. ESMA supports the inclusion in the auditor's report of an explicit statement of compliance with relevant ethical requirements or applicable law or regulation, and the disclosure of the sources of independence and other relevant requirements. This would give substance to the general statement and contribute to the accountability of the auditor.

Section: Disclosure of the Name of the Engagement Partner

Question 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?

27. ESMA supports the disclosure of the name of the engagement partner. In Europe, this issue is already addressed by article 28 of the Audit Directive 43/2006.

Section: Other Improvements to Proposed ISA 700 (Revised)

Question 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?

28. Overall, ESMA supports the proposed changes to ISA 700 except for the flexibility granted in relation to other reporting responsibilities according to which the national standard setters can decide how best to place the auditor's communication about these responsibilities in the auditor's report in order to be meaningful to users. We are unsure of the rationale for such flexibility and ESMA believes that when those other reporting responsibilities are required to be presented, they should be addressed in a separate section of the auditor's report.

Question 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?

29. 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, could create confusion for users and ESMA would not be in favour of it, as already expressed in our comment letter to the IAASB Invitation to Comment. However, it is important to allow for some flexibility if necessary in order to give prominence to those matters of most importance to users.