

James Gunn
IAASB Technical Director
Submitted via website

October 8th 2012

Dear James

IAASB invitation to comment: Improving the Auditor's Report

We welcome the opportunity to respond to the IAASB's invitation to comment on its thoughts regarding improved auditor reports. We are grateful that the IAASB has responded to the calls we and other investors have been making for some time for improvements in this respect. We have consistently called for audit reports that are worth reading, audit reports that are more about what the auditor has done than about what an auditor does not do. These current proposals are steps in the right direction, though we believe that they could be enhanced further.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including PNO Media (Netherlands), Canada's Public Sector Pension Investment Board, VicSuper of Australia and Lothian Pension Fund in the UK (only those clients which have expressly given their support to this response are listed here). In all, EOS advises clients with regard to assets worth a total of \$138 billion.

While improving audit reports matters, it is important to note that for us better audit reports are not an end in themselves, in fact they are almost not important in themselves. The ultimate product of the audit must be quality corporate reporting, so the audit report matters as better reports will encourage a focus on the quality of the audit, will encourage better quality auditing, and so will lead to better reporting by companies.

In order to deliver this aim of better company reporting, it seems to us that two elements are needed in the audit report:

- required disclosures which focus on quality in the audit, thereby helping to encourage greater audit quality over time; and
- required disclosures which enforce a relevant debate between the auditor and both the Board of Directors and/or the audit committee of the Board, meaning there are more leverage points for the auditor to influence improvements in reporting.



Auditors tell us that the simple audit opinion is a blunt tool for getting improvements, useful in the extreme case but harder to wield in more limited circumstances. An audit report with more opportunities for comment provides more leverage points to get better reporting more generally. It also provides a broader basis for dialogue between shareholders and companies in which they invest.


It is against these measures that we assess the IAASB proposals for auditor commentary. This informs the comments that follow. In general, we welcome the proposals. In particular, the following appear to be welcome and positive steps:

- the opinion being placed first
- the going concern commentary being made explicit and being stated in the proposed two separate parts
- the inclusion of a section on auditor commentary, though we have some comments below about the nature of this
- a discussion about the role of other auditors, and the publication of the name of the audit partner
- the explicit statement with regard to the so-called 'read requirement' to reveal any identified material inconsistencies between the other information published in the annual report and the audited financial statements

We welcome these steps, but we also worry that the proposals overall do not go far enough. In particular, we believe that the auditor commentary would be significantly more appropriate if it were genuinely a commentary by the auditor, about the key judgements in the audit, including key risks focused on, the materiality assessment, and the scope of the audit. We believe it is also helpful for the auditor to comment on key accounting judgements, but we believe the best route for such disclosures is for the audit committee to deliver its comments on the key relevant judgements and then for the auditor to respond as to the completeness of these comments. This route to delivering the best and most useful disclosures may not be deliverable in all territories, which is one reason we strongly favour an approach from the IAASB which allows for national and regional variations responding to local governance and other regimes.

We respond to the specific questions below.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Paul Lee', with a horizontal line underneath.

PAUL LEE
Director

Overall considerations

Q1: 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 believe that the proposals represent significant steps forward – notwithstanding opportunities to further enhance them – and that the benefits significantly outweigh the costs. We note that these proposals do not add to the substantive burden on auditors, they simply require those activities and conclusions to be disclosed to investors, so that any added costs should in our view be minimal. Added to which it should be noted that ultimately any increased costs will be borne by investors as shareholders in the companies which pay audit fees and that therefore perceptions of costs and benefits set out by companies should not be given excess weight in any consideration of these proposals.

Q2: 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.

We make specific comments below regarding the Auditor Commentary, which we believe is the area where significant further improvements can be made. We note that in some jurisdictions the aims set out for greater information flows to investors regarding the key accounting judgements may best be met by fuller reporting on these issues by audit committees, with the auditor's role to respond to such reporting. Requiring this goes beyond the IAASB's remit so we believe that the scope for fuller disclosures through this route argues very strongly for flexibility in the IAASB's proposals.

Auditor Commentary

Q3: 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?

We welcome the concept of the Auditor Commentary. However, we note that its predominant focus is accounting judgements; we agree with comments that disclosures on accounting judgements are best made first by the company (preferably by the audit committee) with the auditor responding to those disclosures. We firmly believe that there should be a greater focus on auditing judgements in the auditor's report – issues about which it is appropriate for the auditor to make initial disclosures. By auditing judgements, we mean a disclosure of the key risks as assessed at the start of the audit, and any change in that assessment over the life of the audit, the key areas of focus for the audit team, the level of audit coverage of subsidiaries and segments, and the materiality threshold, both overall and in terms of performance materiality. All of these are vital insights into the quality of the audit and enable investors to assess the value they are getting for the money they are paying for the audit, as well as providing a helpful basis for dialogue between investors and those charged with governance.

We also firmly believe that there is value in the auditor providing commentary on accounting judgements, but we believe that this would be better effected through an auditor response to disclosures by the company – and preferably by those charged with governance – on the key issues of debate and discussion between the auditor and the audit committee. Given that requiring such disclosure of those charged with governance is not in the IAASB's gift, we believe that there must be flexibility in the IAASB proposals to respond to the governance framework of different countries so that this aim can most appropriately be effected.

We have one more suggested improvement to propose to the audit report: where the accounting regime of the audited entity is based on an assumption of neutrality, we believe that the auditor should be required to make an assertion that the accounts are prepared on a neutral basis. This is something, given the relevant accounting regime, on which the auditor will need already to have a view and therefore this will not require additional work by the auditor. It is also a more realistic requirement than that sometimes made by investors that the auditor should make a disclosure as to the degree of aggressiveness of the accounting.

Q4: 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?

We absolutely believe that those issues discussed - and the nature of the discussions - in the Auditor Commentary should be left to the auditor's professional judgement. The aim of the commentary is to gain insights into that professional judgement such that it can be encouraged and supported, thereby enhancing audit quality. Thus professional judgement is the only appropriate basis for determining the content and nature of the reports. Even where, as we suggest, the auditor is responding to the discussion by the audit committee of the key accounting judgements, we firmly believe that the auditor commentary must be directed solely on the basis of the auditor's professional judgement.

Q5: 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?

We do not believe that the IAASB's proposals are well-served by the examples provided. These seem too generic, too standardised, to provide genuine insights into the audit. This tendency to boilerplate reinforces our view that (1) the auditor commentary should focus first on the key auditing judgements and (2) the discussion of key accounting judgements will be most useful to investors where the auditor is responding to disclosures made initially by the audit committee.

Q6: 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?

We believe that in an ideal world there would be a consistent role for those charged with governance (generally for convenience referred to as the audit committee in this response) to make the initial disclosures on the key accounting judgements and the discussions between the auditor and the company. This would maintain the right balance of those who are best placed to make disclosures being required to do so. As this is not wholly in the gift of the IAASB, given the extent of its powers, we believe that the proposals should be designed with flexibility to respond to the specific governance regimes in different markets to enable this more effective route to disclosure to be taken where possible. This would probably mean that the IAASB requirement would need to be that the auditor must make this disclosure if it has not been made otherwise in the annual report; where it has been made, the auditor would be required to comment on its accuracy and completeness, making any necessary disclosures to ensure that it is complete.

With regards to cost, we believe that the vast majority of what is proposed is simply a formal and public articulation of the work that the auditor already does and that there should therefore be minimal implications in terms of cost. We would also note that the benefits far outweigh those costs – which would in any case be borne by investors – and that in many regimes around the world investors have the power to approve the auditor fees, giving a direct feedback loop on the appropriateness of the cost of the audit.

Q7: 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?

Our view is that auditor commentary is needed for public companies (ie those whose equity or debt is traded on a public market), and that this approach should be voluntary for any other audited entity.

Going concern/Other information

Q8: 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?

We are firm supporters of the proposals on going concern, particularly the inclusion of the two separate elements. While the first, on the going concern assumption, will provide little that amounts to news, its assertion is helpful. The second, on material uncertainties, offers an opportunity for auditors to provide disclosures of real value to

investors which may in some circumstances even help avert crises by providing investors with a trigger for intervention at troubled companies.

Q9: 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?

We believe that there is value in encouraging such disclosures. The Invitation to Comment notes that this may be difficult where the company has not itself made any relevant disclosures, but we would note that in practice the ability for the auditor to make such disclosures would serve to encourage the company to make disclosures about which it might otherwise be reluctant. This is certainly the experience in other areas where the auditor has a right to make a statement, and the value to investors of this power for the auditor would therefore be very important indeed.

Q10: What are your views on the value and impediments of the suggested auditor statement in relation to other information?

We welcome the inclusion of a formal statement by the auditor with regard to other information. We believe that this is an important role that the auditor performs and bringing it formally into the open - making clear the extent of and limits to the role - adds real value. We would hope that in the IAASB's current consideration of this so-called 'read requirement' it could be extended to cover materials published concurrently with the audited statements to the same constituency, and that it would be based not just on a comparison with the audited statements but on the auditor's understanding of the company gained through the audit. We believe that the best auditors already take just such an approach.

Clarification and Transparency

Q11: 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 welcome the inclusion of the phrase "we exercise professional judgment and maintain professional skepticism through the planning and performing of the audit" as we believe this is a useful and important framing of the audit in terms of professionalism and scepticism. However, our firm's view is that these boilerplate statements should not be included within the auditor report. Ideally, they would be disclosed on a website, but alternatively they could be included as an appendix to the auditor report, ie beginning after all the other disclosures (including the report on other legal and regulatory requirements), and ideally after the signature of the auditor and the date.

Q12: What are your views on the value and impediments of disclosing the name of the engagement partner?

We welcome the disclosure of the audit partner as we believe it personalises the responsibility and brings home to the individual their duty to deliver a quality audit for the shareholders. Our discussions with audit partners indicate that these are in practice the implications of this disclosure in those many markets where the naming of the audit partner is already required.

Q13: 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?

We believe that it is helpful to disclose other auditors involved in the audit, both to reveal the nature of the arm's length relationships within the audit networks and to illuminate those situations where significant portions of the audit are performed by firms other than that which signs the group audit opinion. To respond to the concerns that this might be seen as in some way undermining the specific responsibility for the audit opinion, in our view such disclosures should be made outside the audit report ie after the signature and date. To be material, we would suggest that the disclosures should only include any audit firm with an aggregate role in relation to 5% or more of the audited entity's assets or profits, and we would suggest that the firms be listed in order of proportions of the overall audit fees, which should also be disclosed against each firm (in percentage terms, not absolute fee levels).

Q14: 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 that the best place for such boilerplate is a website. A second best is as an appendix to the auditor's report. Inclusion within the auditor's report is not welcome and acts contrary to the intent to make auditor's reports entity specific and relevant.

Form and Structure

Q15: 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?

We believe that the ordering is helpful, and that the proposed structure is appropriate – once the standardised text on responsibilities is removed to a website or appendix. As noted above, we would suggest that disclosures about other auditors involved in the audit would be better placed after the signature and date on the audit report.

Q16: 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?

Our firm view is that the IAASB proposals must not seek global consistency, but rather should favour allowing different national and regional standard-setters to respond to the aims of these proposals in the way that best reflects their local governance and legal frameworks. To do otherwise would be highly ironic in proposals which are seeking much more entity-specific and relevant disclosures. We believe that the IAASB must follow the logic of these aims and not require global consistency that may lead to irrelevant disclosures that do not respond to the nature and circumstances of the entity.

Q17: 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 would be comfortable with mandated ordering of the elements, provided there was flexibility to respond to law or regulation. As stated above, we believe that the order that the IAASB is currently contemplating is appropriate and runs in order of importance of these matters to investors.

Q18: 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?

Our view is that this approach is needed for public companies (ie those whose equity or debt is traded on a public market), and that it should be voluntary for any other audited entity.