Federation of European Accountants
Fédération des Experts comptables Européens

Mr James Gunn
Technical Director
IAASB
545 Fifth Avenue, 14th Floor
New York, New York 10017
USA

6 November 2013

Ref.: AUD/AKI/HBL/NRO/EBL

Dear Mr Gunn,

Re: IAASB Exposure Draft (ED) 'Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)'

FEE[1] is pleased to provide you with its comments on the Exposure Draft (ED) 'Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)'. FEE welcomes the ED and most of the proposals included therein. We note the progress made by the IAASB and the extent to which FEE's earlier comments have been addressed.

FEE welcomes the emphasis that the IAASB will put on field testing: it will help the profession implement the proposals and enhance best practices.

Firstly, FEE wishes to highlight two major issues linked to the ED:

- The currently proposed EU legislation is not entirely consistent with the IAASB ED. FEE is of the opinion that the IAASB proposals provide a better response to stakeholders' needs with regard to auditor communication. For this reason, we suggest the IAASB maintains close contacts with the European Commission (EC), the European Parliament and the Council of the European Union (Member States) which remain undecided as far as auditor reporting and other audit policy matters are concerned. It is of utmost importance that article 22 of the EC proposed Regulation[2] and the ISAs should remain compatible.

[1] FEE (Fédération des Experts comptables Européens - Federation of European Accountants) is an international non-profit organisation based in Brussels that represents 45 institutes of professional accountants and auditors from 33 European countries, including all of the 28 European Union (EU) Member States.

FEE has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big accountancy firms, businesses of all sizes, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

[2] http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf

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Association International reconnue par Arrêté Royal en date du 30 décembre 1986

- The current PCAOB proposals (Docket 034) on the same subject matter are similar to those of the IAASB, but differ in some detailed aspects. FEE is currently working on a comment letter to the PCAOB in which we will reiterate our strong preference for an alignment in auditing standards worldwide, to the maximum degree possible; this would be particularly beneficial for capital market participants with cross-border interests and global activities.

Secondly, our main comments on the ED are summarised below:

1. Going concern

We fully support the principles underlying the proposed requirement for explicit reporting of the auditor's conclusions that are only implicit under the current ISA 570, but have some concerns with the detailed proposed changes to ISA 570.

In particular, according to our analysis that is further detailed in the responses to the questions below, the level of detail may be excessive in those cases where there are no specific going concern issues. Furthermore, the proposed wording on responsibilities blurs the respective responsibilities of management and auditors and, therefore, needs to be reconsidered. FEE believes that the audit report should not become an original source of information about the entity, especially about going concern assumptions.

2. Content of Key Audit Matters (KAM) paragraphs

More guidance is needed to inform the auditor's consideration of what should be included as a KAM and what would be in the description of a KAM. It is important that there is consistency in its application and that users obtain useful information. FEE believes that users will obtain more insight from information on the audit approach undertaken in response to a KAM and the key audit findings, in particular on aspects of information reported in the financial statements. In addition, the inclusion of a clear reference to the related disclosure in the financial statements will enhance the users' understanding.

As far as issues related to material uncertainties and going concern, there should be a clear requirement that they should be included as a KAM if the definition of a KAM is met. However, we believe that the going concern KAM should be included in the going concern section of the auditor's report.

Lastly, FEE notes that there is no question dedicated to the scope of the proposal other than its application to listed entities. FEE appreciates that this is a matter for national regulation to prescribe; however, FEE is aware that some challenge the usefulness of KAM for small listed entities, whilst others would prefer the standard to apply to all audits.

3. KAM on a voluntary basis

FEE agrees that it is sensible to foresee the opportunity to disclose KAM on a voluntary basis. Nevertheless, while thinking about how this would work in practice, we conclude that due consideration should be given to the need for an appropriate mechanism to prevent the possibility for the entity to only apply KAM voluntarily when it is convenient ('pick and choose').

We consider these IAASB proposals as an experiment, and that time will be needed to adapt and develop best practice. FEE is committed to informing the debate further and to helping its Members develop best practices.

For further information on this FEE letter, please contact Hilde Blomme at +32 2 285 40 77 or via email at hilde.blomme@fee.be or Noémi Robert at +32 2 285 40 80 or via email at noemi.robert@fee.be from the FEE Secretariat.

Yours sincerely,

André Kilesse	Olivier Boutellis-Taft
FEE President	Chief Executive

Appendix: Responses to Questions

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?

Yes. We agree it is appropriate for the auditor to report Key Audit Matters (KAM), rather than to report *matters likely to be most important to users' understanding of the audited financial statements or the audit* – as included in the ITC's previous proposal. We subscribe to the KAM principle approach as proposed by the IAASB, as it also may better prevent boilerplate statements. We do have some concerns which are set out in our response to Questions 2 to 5.

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?

Although we agree that it is appropriate for the auditor to report KAM, the framework proposed to guide the auditor in <u>determining</u> KAM raises the following concerns:

- We agree that determining KAM should remain principles-based, but wonder whether there is sufficient guidance on what the concept 'of most significance' means. The concept may be too ambiguous to effectively draw the line between the risks that have to be reported and these that need not be reported; also the word "most" implies there will always be at least one KAM. Please refer to our main response to Question 6.

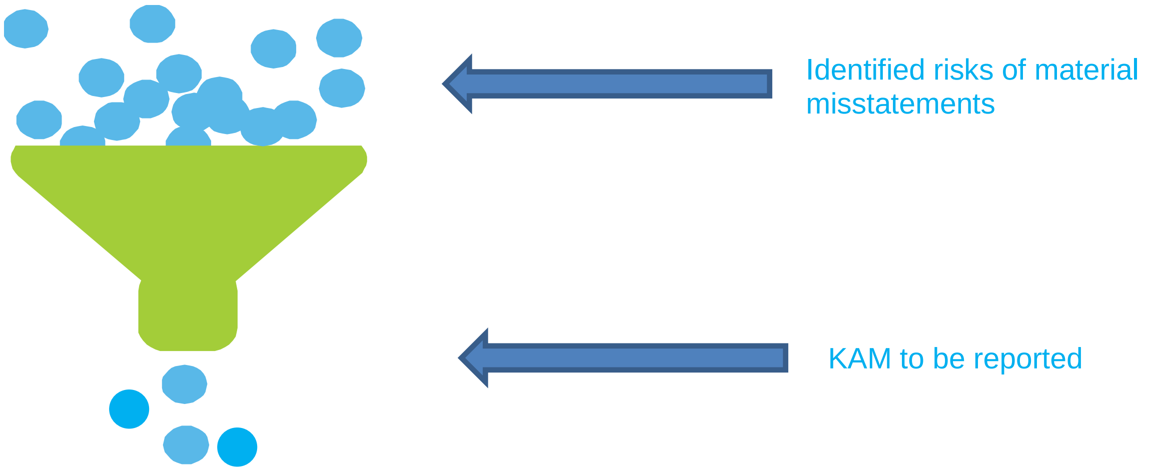
We considered whether it should be 'significant *<u>to users</u>*' instead of 'in the audit of financial statements'. The stated primary aim of the IAASB proposal is to provide more information about the audit to users (i.e., the decision-usefulness of information included within a KAM section of the auditor's report). Nevertheless, it is not straightforward to know what is most significant *for users*, as auditors cannot substitute their viewpoint for users' perspectives. Therefore, whilst we do believe it should be left to the professional judgement of the auditor to decide what should be a KAM, it should be emphasised that the auditor should take into account what they believe would be of interest to users.

- The requirements set out in paragraph 8 (a), (b) and (c) are all areas that could be identified as significant risks in accordance with ISA 315 (8 (b) and (c) can be considered as subsets of 8 (a)). This renders the guidance on 'determining Key Audit Matters' overly complicated which could be more specific and clearer.

Generally speaking, FEE favours having clearer requirements supported by appropriate application material to better frame which identified significant risks should be reported in the KAM section. Our proposal is to improve the IAASB proposals on how to select KAM in a principles-based or professionally judgemental way (concept of the 'funnel process'):

- ✓ Identification of the potential KAM in the identified significant risks of material misstatements;
- ✓ As a subset of the identified risks of material misstatements, the KAM to be reported in the audit report should be the ones that would be decision-useful and

relevant to users of financial statements – in general, with the possibility to include a clear linkage with the financial statements.



- Both the number of items and the length of descriptions would need to be limited – in order to avoid lengthy paragraphs or reverting to boilerplate information. To this end, we strongly support paragraphs A7 and A8 of ISA 701;

- We have concerns that the guidance is limited to how to communicate and report KAM (see also our response to Question 3).

The adopted IAASB audit reporting standard should explicitly acknowledge that the auditor cannot expand on a KAM about which the company has not provided information in the financial statements.

It should be emphasised that there are cases that can be contentious and difficult to tackle. For instance, the auditor may determine that a weakness in the IT system is a KAM having identified it as a significant risk of material misstatement during the audit. The auditor will have reported its internal control assessment to those charged with governance (TCWG), and would like to write a KAM paragraph on this matter. What if the company has not disclosed this risk in the financial statements, which is highly likely for this type of risk? To mitigate this risk, as stated above, FEE considers there should be a **clear linkage** between the financial statements and other information accompanying the financial statements, and the KAM. This linkage would:

- Enhance the dialogue between auditors and TCWG, including audit committees;
- Improve the financial reporting by companies; and most importantly;
- Help the auditors apply their professional judgement in reporting potential contentious cases – such as the one described above.

In this regard, to help the auditor resolve contentious cases, it may be strategic to state in the ISA that discussions with the entity will be needed as to why an entity has not disclosed the issue and that the auditor will take this into account when forming the audit opinion.

Finally, we consider that the KAM proposals are an **experiment**, and that time will be needed to adapt and develop best practice. The application material included in the ISAs, informative as it is, cannot respond to all possible questions which are bound to arise when applying KAM auditor reporting in practice.

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?

In the requirements, paragraph 10 (a), as drafted, shows a lack of clarity and could be read in different ways. For example, from a user perspective (decision-usefulness), providing lengthy reasons for selecting a particular matter for inclusion as a KAM and the impact on the audit should not be necessary in all but exceptional circumstances. It may be relevant to insist on the disclosure of the outcome of the audit work as we think that it is what is most important for users. We agree with paragraph A38 in the application material which states that "[…] this may include a brief overview of procedures performed or the auditor's approach to the matter, or may include an indication of the outcome of the auditor's procedures with respect to the matter". We recommend including this sentence (or an equivalent) in the requirement section of the standard as further explanation of the requirement.

In the application material, to facilitate appropriate consideration of what should be included in the descriptions of KAM, we suggest further guidance may be needed. Added-value from the auditor's report will be provided by giving the following information for each KAM reported:

- A clear reference to the related disclosure in the financial statements. This reference will help the users to link the point raised by the auditor to the disclosures, but not necessarily to navigate the users through the financial statements;
- The nature of the KAM;
- The audit approach undertaken in response to this matter; and
- The key findings from that audit work.

FEE stresses that it is important to avoid piecemeal opinions. In view of this, FEE appreciates that, in compliance with paragraph 9 (d) of ISA 701, the auditor's report shall state that "the auditor's opinion on the financial statements is not modified with respect to any of the KAM, and the auditor does not express an opinion on these individual matters." In addition, for the sake of clarity, it can be stated in the beginning of the ISA that KAM do not modify the opinion of the auditor's report. Paragraph 11 of ISA 701 does not deal adequately with this issue.

In addition, we would like to draw attention to how going concern matters are tackled in ISA 701: we would very much welcome a clear requirement that going concern issues should be included as a KAM if the definition of a KAM is met. However, we believe that the IAASB ought to consider whether going concern KAM should be included in the going concern section of the auditor's report. In cases where, following a considerable amount of audit work, the auditor concludes that there is no material uncertainty, the audit report should be clear on the audit work performed on the going concern issues as required in a KAM. It might seem sensible that this be included with the conclusion on going concern. We believe that the standard should be clear about whether a KAM would be included on going concern, and also whether in these circumstances it should be included in the going concern section of the audit report.

With respect to going concern disclosures and their interrelation with KAM and Emphasis of Matter (EOM) paragraphs, we also refer to our response to Question 8.

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.

As the IAASB is aware, the examples given in the ED are not consistently structured. They differ in nature and quality – most probably for exposure period purposes. This highlights the need for consistency, as their reading is not effortless, which raises the concern that these examples might not help auditors who are trying to report KAM paragraphs on the same level playing field and with the same quality and value to users. **These examples should not be included in this form and shape in the final standard; the final standard should at least meet the requirement of consistency between examples**.

FEE has carried out some work in this area and published a policy statement in July 2012 with regard to 'improved auditor reporting' which contains some examples, which follow a similar structure. This policy statement is accessible via the following link and attached to this letter:
http://www.fee.be/images/publications/auditing/PS_120709_-_Policy_Statement_on_Improved_Auditor_Reporting_1372012371225.pdf

In light of our response to Question 3 and the approach that we would favour when reporting KAM, we have the following comments on the examples proposed by the IAASB:

- The example on 'Acquisition of XYZ Business' is for instance a very weak one, without a real added-value to users. It could be seen indeed just as an enhanced EOM, but the reader may need more information, such as what the auditor has done and what was the outcome;
- On the contrary, the example on 'Valuation of Financial Instruments' is very well structured. The references to the note included in the financial statements, the background information about the matter, the audit response and the conclusion on this matter are well presented. This example can be considered as very informative and in accordance with the principles tailored in our response to question 3. It will therefore add value to users;
- The example on 'Revenue Recognition Relating to Long-Term Contracts' is worrying and unhelpful, especially:
    - With the statement on the side agreement: the example is likely to create a high degree of uncertainty for users, which does not serve any purpose ('[…] we did not find evidence of the existence of side agreements'). We do not support retention of this example in the final standard.
    - With the use of the word 'fraud' for the following reasons; firstly, it might be difficult to understand for some entities and users why we use the word 'fraud' in an unqualified audit report. Secondly, fraud can be translated in different ways in different languages, and in some countries, it is translated as a legal term within the sense of criminal or penal law whereas in other countries, it is not translated in such a way. Lastly, this word is included seven times in the illustrative report: given the issue of translation explained above, the use of the work fraud in the audit report needs to be amended;
- The example on 'Goodwill', even if it could become boilerplate, can be considered as a good example.

We acknowledge the difficulty to create examples in a vacuum, field testing will be of utmost importance in this regard.

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?

Having discussed within FEE about the various issues that the auditor could encounter when applying KAM on a voluntary basis, we concluded that:

- KAM ought to be required for listed entities and entities governed by local regulation (for instance it could be relevant for subsidiaries of banks, in order to have the same format of the group audit report). This will ensure the same level playing field and will avoid any kind of manipulation from the entity's side, or from the market.

- Even if it is allowed on a contractual basis, the contract should prohibit subsequent renegotiation of the clause.

  Indeed, if the auditor includes the reporting of KAM in the contractual engagement letter following discussion with the entity or acceptance of the engagement of the content of such letter, depending on the KAM to be reported at the end of the audit, pressure may be exerted by management or those charged with governance to adapt or remove some or all KAM from the audit report. To counteract this, it should be clear within the standard that, if the reporting of KAM is added to the contractual engagement letter, it is not possible to opt out (in whole or in part) at the end of the audit; we should definitely prevent the possibility for the entity to 'pick and choose'. This also applies with respect to consistency of application as it would not be desirable to permit KAM to be reported one year and not the next, particularly where issues previously reported remain in the subsequent year.

Thus, there needs to be a mechanism to present the respective responsibilities between the auditor and the entity more accurately. Once the entity has agreed to KAM reporting, the entity should not be allowed to subsequently change its mind and come back from this decision. In case the entity does, the auditor should treat such situation as a limitation of scope (e.g. if there is an issue with confidentiality). We therefore suggest the IAASB include requirements to address this when ISA 701 is applied voluntarily.

We acknowledge that the explanatory memorandum (ISA 700 paragraph 30 and ISA 701 paragraph 4) explains the intention that, when ISA 701 is applied voluntarily, the entire standard applies. This also ought to be reflected in the standard itself.

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?

Yes, we agree that it is appropriate to include the possibility that the auditor may determine that there are no key audit matters to communicate. Nevertheless, we consider this should be applicable in rare cases only. For instance, for some listed holding companies - whose own activities are minimal – it would be sensible not to report KAM in the auditor report.

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

Yes, we agree that the requirements of paragraph 13 are necessary to ensure an appropriate process and communication where the expectation of users for disclosure of KAM is not met. In this context, we also refer to our response to Question 2 first bullet of the first paragraph, as the word “most” in the definition of KAM implies there will always be at least one such matter.

(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?

Not applicable

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?

Yes, we agree that, when comparative financial information is presented, the auditor’s communication of KAM should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65.

Nevertheless, comparing this proposal with the ones from the PCAOB in this regard – paragraph 10 on page A1/8 – we prefer the PCAOB proposal which we consider very clear on what is meant and what is expected from the auditor with regard to comparative financial information auditor reporting[3].

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?

We agree with the IAASB’s decision to retain the concepts of Emphasis of Matter (EOM) paragraphs and Other Matter (OM) paragraphs.

However, there is still a need to **further clarify the interaction between KAM, going concern and EOM paragraphs**. How should these disclosures link across? In what order should they be presented?

We think that the example audit report will strongly influence the application of the standard in the early stages of implementation. With regard to the hierarchy of ordering the different disclosures in the example included in the standard:

[3] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf

- The going concern information is the one that should be disclosed upfront, after the audit opinion. Indeed, going concern information has been identified as strategic in users' expectations; it is the auditor's duty to put it upfront in the audit report. We refer to our concerns with regard to the wording of this paragraph in our response to Question 9;
- The EOM paragraphs, if any, should be disclosed just after the going concern reporting piece and should contain a higher level of detail than KAM. The use of EOM and KAM is different, it should not be mixed up. Reporting in EOM is not linked to the audit work, but to mandatory disclosures in some jurisdictions or according to specific ISA requirements (for example, subsequent events in ISA 706);
- For the sake of clarity, going concern issues should be included as a KAM if the definition of a KAM is met. However, we believe that the going concern KAM should be included in the going concern section of the auditor's report (please refer to our response to Question 3).

We also believe that the reference to "materiality" as possible content of the OM paragraph in ISA 706 paragraph A8 of the application material might encourage such disclosures, even when law, regulation or national standards do not require them. In our view, this reference in the application material should be deleted at this time until more work has been undertaken on whether the disclosure of materiality is useful to users. This will ensure consistent global application.

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.

FEE agrees that the auditor should do more regarding the going concern assumptions and the reporting thereon. FEE is concerned about the risk of increasing the expectations gap relating to going concern reporting. The example paragraph in the illustrative report and appendix may not be understandable to users and may result in unrealistic expectations on their part: it is more likely to confuse the readers than it would inform them, especially for the following reasons:

- The section is too long, especially considering that there is no going concern issue;
- The sequence of sentences used in the second paragraph is not logical, primarily because the conclusion is in the middle of the section paragraph 20 (b) ("[…] the auditor has concluded that management's use of going concern […]");
- The proposed wording may result in readers perceiving a higher degree of comfort than intended;
- The end of paragraph 20 (b) acknowledges that "management's use of the going concern basis of accounting […] is appropriate" while the following paragraph 20 (c) and (d) provide more detail and use wording that might disturb the reader, such as the last sentence "However, neither management nor the auditor can guarantee the Group's ability to continue as a going concern". Whilst not factually inaccurate, this sentence

seems to imply that both management and the auditor have a similar level of responsibilities whereas previously, it is rightly stated that management has primary responsibility in this respect (see our response to Question 10).

If we want to inform users and be explicit, we have to avoid the use of boilerplate language, which is not the case in this proposal. We would propose to differentiate three scenarios in relation to going concern reporting in the ISA by applying different reporting requirements:

- No going concern issue: only brief disclosures that will for instance include the sentence reported in paragraph 20(b) of ISA 570 (i.e., not including further mention of material uncertainties);
- Potential going concern issue: more extensive disclosures that will for instance include more details about the work carried out by the auditor in this regard and the conclusion that “the auditor has not identified a material uncertainty that may cast […]” (paragraph 20 (c)) (i.e., KAM – see our response to Question 3);
- Clear going concern issue: significantly more details to be provided, with a clear reference to the management disclosure in the financial statements (i.e., KAM – see our response to Question 3).

In addition, instead of paragraph 20 (b), we would propose a statement that is more explicit, such as “As part of our audit, we conclude, according to our professional judgment, the going concern assumptions of management are appropriate”.

As of today, two standards deal with going concern disclosures on EU level:

- The International Accounting Standards (IAS) 1 where the requirement is very limited. In this respect, FEE is pleased to see this subject matter on the agenda of the IASB for the last quarter of 2013[4]. **Therefore, we question whether the going concern disclosure requirements put forward by the IAASB should not be conditional to the outcome of the IASB work on the audit client’s disclosures in the financial statements in this regard?**
- The new EU accounting directive approved on 26 June 2013[5] stating the following: *“[…] Recital (24) Disclosure in respect of accounting policies is one of the key elements of the notes to the financial statements. Such disclosure should include, in particular, the measurement bases applied to various items, a statement on the conformity of those accounting policies with the going concern concept and any significant changes to the accounting policies adopted.”*

In parallel with the IAASB’s effort, expanding the accounting and financial reporting standards relating to going concern reporting by the company is essential.

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?

Whilst we appreciate the principle behind requiring such a statement, we are of the view that such a statement would confuse the reader and, in particular, the last sentence “*neither management*

[4] http://www.ifrs.org/Current-Projects/IASB-Projects/Pages/IASB-Work-Plan.aspx
[5] Published on 29 June 2013 in the Official Journal of the European Union: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:182:0019:0076:EN:PDF

nor the auditor can guarantee the entity's ability to continue as a going concern". This statement could be misinterpreted by users for the following reasons:

- The verb 'guarantee' is too open for interpretation;
- The auditor should not be in the position to report on matters which are within management's responsibilities;
- Management has primary responsibility for the accounts presented in the financial statements. The current text mixes up responsibilities as it seems to place the management and the auditor at the same level of responsibilities against this 'guarantee'.

If the IAASB decides to retain this statement, it will need to be redrafted in order to present the respective responsibilities more accurately.

Compliance with Independence and Other Relevant Ethical 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?

Yes, we agree that such disclosure would increase transparency. We agree with the benefits of confirming auditor independence, but are concerned about the proposal to require potentially extensive paragraphs disclosing the source(s) of independence and other relevant ethical requirements in the auditor's report (paragraph 28 (c) of ISA 700); indeed we question the practicability as well as the decision-relevance of the latter from a user perspective.

It may be needed to explicitly state that this paragraph should be kept concise. According to FEE, this descriptive subparagraph of the auditor's report should be brief and non-ambiguous and could be aligned to ISA 200 paragraph 14. The ISA should be more explicit with regard to the level of details required to ensure that we will avoid lengthy lists of ethical requirements or applicable law or regulation.

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?

FEE has not identified any impediments against disclosing the name of the engagement partner in the auditor's report. This is already required in the European Union (EU) under the Statutory Audit Directive of 2006 (2006/43/EC).

FEE supports the 'harm's way exemption' included in the ED. There is an expectation that the use of such exemption would be rare. Nevertheless, it is necessary and in accordance with the public interest.

<u>**Other Improvements to Proposed ISA 700 (Revised)**</u>

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?

With respect to the improved description of the responsibilities of the auditor and key features of the audit

The description of responsibilities is improved.

With respect to the provision for the descriptions of the responsibilities of the auditor and key features of the audit to be relocated to an appendix in the auditor's report, or for reference to be made to such a description on the website of an appropriate authority.

Yes, FEE supports this provision. Removing lengthy descriptive paragraphs, to the extent permitted under EU legislation, will improve readability of the auditor report. The flexibility proposed in ISA 700 allows appropriate tailoring in particular jurisdictions or circumstances. However, inclusion of material on a website should only be permissible when allowed by national standard setters or legislators.

With respect to the reference to whom in the entity is responsible for overseeing the Company's financial reporting process

Yes, FEE supports this reference: the disclosure is informative and its flexibility allows appropriate tailoring in particular jurisdictions or circumstances.

With respect to other reporting responsibilities (no longer necessarily in a separate section but clearly differentiated)

The reason advanced by the IAASB is acceptable ("the proposed new sections in the auditor's report relate to areas for which there may be additional reporting responsibilities […] it is appropriate to allow additional flexibility for national standard setters to determine […]"), FEE would therefore support such flexibility offered to national standard setters or legislators, but this flexibility should not extend beyond such authorized bodies.

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?

FEE supports 'global standardisation' of the auditor's report, including the ordering of the paragraphs. This would help:

- Navigate users through the auditor's report;
- Provide a comparison between auditor's reports; as well as
- Develop recognition for the IAASB and its ISAs as the leader in cutting edge proposals to significantly enhance transparency in auditor reporting.

We acknowledge that the IAASB could mandate the ordering unless local regulations and other local differences apply.

FEE welcomes the proposals of the IAASB to mitigate the risk of losing consistency at global level. For instance, the requirements to include separate headings – as per paragraphs 20-45 of ISA 700 – are strategic. Indeed, even if the paragraph order differs between jurisdictions, the reader can use those subheadings to navigate the report easily. The comparison between auditor's reports will also be straightforward.

In addition FEE recommends IAASB to consider reversing the order of the first two paragraphs so that the subject matter of the audit is specified before the opinion thereon is expressed. There is merit in having the paragraph that specifies the subject matter of the audit to be first. Of course, the exception for law or regulation would continue to apply.

FEE Federation of European Accountants
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Policy Statement

Standing for trust and integrity

July 2012

FEE Policy Statement on Improved Auditor Reporting

The informative value of public audit reports and the auditor communications with the audited entity should be enhanced. Widely accepted general principles for the content of future auditor communications will benefit all stakeholders.

As far as public auditor reporting is concerned, this can be done through providing more information in the audit report regarding the auditor's view on the use of the going concern assumption by management. In addition, information in relation to the audit approach used in respect of the entity's specific significant audit risks should be included. The audit report accompanies the entity's financial statements and the additional auditor reporting will help to add credibility to those financial statements.

This forms part of the initiatives to enhance financial reporting from entities and supports investors in making better informed investment decisions. Principles-based initiatives that support these objectives, including improving auditor communication, are a high priority of the audit profession.

With the unfolding of the financial crisis, an assessment of how audit services can continue to enhance their contribution to the economy and to society is appropriate and timely. An important role of the audit profession is to add transparency to and provide comfort on the reliability of financial reporting. Recent debate has highlighted the need to provide the public with more details about what an audit is and what the output of an audit is.

European Commission proposals and international initiatives

The European Commission published in November 2011 its proposals to reform the European audit market. The proposals include suggested changes to the way auditors communicate externally in the public audit report and internally to the entity's audit committee or supervisory board for audits of public interest entities.

Auditor reporting should not be dealt with by Regulation

As the representative organisation of the European accountancy profession, FEE is committed to advancing audit policy across the EU and globally. This would require striking a proper balance between the need to provide consistent common principles and requirements while acknowledging the (sometimes significant) differences in size, structure, complexity and type of economies of EU Member States. While we recognise the importance of fostering harmonisation in accordance with the EU legal competences, we believe that EU intervention in these matters and especially as regards company law, needs to continue complying with the principles of subsidiarity and especially proportionality.

Therefore, FEE recommends the European Institutions to reassess the choice of a European Regulation as the legal instrument to change statutory audit of public interest entities. In line with the choice made regarding the current Statutory Audit Directive (2006/43/EC), it would be more appropriate and proportionate to continue dealing with the provision of statutory audit services to companies which are public interest entities in a European Directive. Furthermore, in view of the objective – that FEE supports – of enabling new entrants on the market of statutory audit services for public interest entities, it does not appear opportune to split the legislation of statutory audit in two different instruments, a Directive and a Regulation, as this may increase barriers to entry on the public interest entities audit market.

Our recommendations below are therefore not aimed at endorsing the legal instrument of a Regulation, but intend to encourage a common approach on auditor reporting by other legislative means.

FEE fully supports initiatives that will lead to having an audit report that is more user friendly, easier to understand and more informative. With this in mind, FEE supports the European Commission's aim of enhancing auditor's public communication for public interest entities. Especially the proposal for more disclosures regarding the auditor's view on the use of the going concern assumption by management is relevant. With regard to some of the details of the proposals, FEE believes that they could be made more practicable and useful by making them less prescriptive and allowing the auditor to use judgement on what information about the individual entity should be reported.

The European Commission also regulates the content of the audit report for non-public interest entities in the fourth company law Directive on financial statements. FEE agrees that information needs of users of audit reports for public interest and non-public interest entities differ. However, as most of the additional matters proposed for public interest entities audit reports are not proposed for audit reports for non-public interest entities, the comparability between audit reports in different segments of the market will be severely diminished. **FEE believes that there should be a single audit report for all entities that is scalable to provide for the differing information needs.** For instance, the statutory auditor could do more, especially in relation to the management report of public interest entities, and not only perform a consistency check between the management report and the financial statements, but also state whether the management report as a whole is suitable in the context of the auditor's knowledge and understanding of the company's business obtained during such audit.

International solutions for auditor reporting are preferable

FEE notes that the International Auditing and Assurance Standards Board (IAASB) is currently developing a new international approach to audit reports which aims at enhancing the communicative value of auditor reporting to its users. This work has been accelerated in order to meet the demands of wider stakeholder groups[1]. Furthermore, the US Public Company Accounting Oversight Board (PCAOB) is also considering these issues. FEE believes that global solutions for audit reports are preferable and will benefit investors and other users. **FEE therefore supports cooperating internationally towards a solution regarding auditor reporting.**

Audit and financial reporting

Audit has become more complex over recent years as the complexity of entities' business models and financial reporting has increased and will continue to do so. **New solutions for auditor communication should be sufficiently flexible to allow for further developments in financial reporting.** This would ensure that the core service of the audit profession, the audit, continues to be valued by its users as relevant and of quality.

Similar to users' expectations with regard to financial statements, users are looking for entity specific information on the audit rather than the current standard "*one size fits all*" audit report, following from an audit which is each time based on the same sound audit principles. Any improvements made should ensure that the quality of auditor's communication meets user needs.

Communication flow

It is the responsibility of the governing body of an entity to provide information about the entity to users. After the auditor has issued the audit report to the audited entity, the entity makes the audit report available to the public together with the financial statements. In this regard, the public represents existing and potential shareholders, as well as other users that have an interest in the audited financial information of a particular entity. **The function of the audit report is to accompany the financial statement information provided by the audited entity itself and add credibility to that information.** Furthermore, the entity provides other financial information to the public that may or may not be accompanied by an independent opinion from an auditor.

Some information gathered by auditors during the audit is more suitable for internal purposes than for publication in the audit report, for instance information that supports the audit committee in its monitoring responsibilities of an effective accounting and related internal control system.

In supporting the audited entity in delivering financial information of quality, the auditor already communicates regularly and frequently with the audited entity based on the current requirements in the International Standards on Auditing ISA 260 and 265[2]. **The concept of the internal report to the audit committee proposed by the European Commission is appropriate** and will, alongside other communications and discussions between the auditor and the audit committee, contribute to strengthening the communication between the two parties.

The public as well as the audit committee receive information from numerous sources. To avoid information overload and duplication of information, the information provided should be as specific as possible and should aim at increasing the knowledge about the audited entity.

Key areas in auditor reporting: tailored to the information needs of stakeholders

The key issues raised by the European Commission regarding auditor communication deal with the auditor's view as to the entity's own assumption that it is going concern, the audit approach and the auditor's assessment of relevant internal control deficiencies within the entity, as proposed in Article 22 of the Regulation. These are all issues that are important to users. The level of detail provided in the audit report will differ from one entity to another with the entity specific information focusing on the work that the auditor has done, and ordinarily not on the business risks the entity has identified although they might be linked.

In this respect, the **EC proposals should be made more principles-based and practical**. These key topics are further discussed below.

Going concern

The auditor can be more explicit regarding the audit work performed in the area of going concern within the external audit report and in its communications to the audit committee.

The primary responsibility to provide information about an entity, such as financial statements and the reasons underlying management's use of the going concern assumption, belongs to its management. Unlike Credit Rating Agencies, the auditor is not an information provider in this respect. **The audit report is therefore not by itself an indication for an investor on whether a particular entity will continue as a going concern. The audit report is based on the information included in the financial statements by management and must be read in conjunction with these financial statements that it accompanies.**

Currently, there is no Europe-wide requirement for the entity to explicitly include comments on its going concern assumptions in the financial statements. With the growing interest in additional information on going concern assessments from investors, entities should be required to provide more information on the assumptions and other information they have used to support management's assertion that the entity would be able to continue its activities in the foreseeable future, currently normally for a period of at least one year. This is especially important in situations where there *may* be concerns about

[1] An IAASB Invitation to Comment on Improving the Auditor's Report was issued on 22 June 2012, https://www.ifac.org/sites/default/files/publications/files/Auditor_Reporting_Invitation_to_Comment-final_0.pdf
[2] ISA 260 Communication with Those Charged with Governance and ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

the impact of future events. Additionally, the information provided should in general be proportionate to the size and complexity of the entity.

Disclosures in the financial statements should be categorised in three categories:

- No going concern problems: only brief disclosures.
- Potential going concern problems: more extensive disclosures.
- Clear going concern problems: significantly more details to be provided.

With this additional information from management on going concern, the auditor would be well placed to give a view regarding the conclusions drawn during the audit in respect of management's use of the going concern assumption. This additional information would be based on information and audit work that is already included in the audit file. The disclosure in the audit report should be as entity specific as possible. **Compared to the European Commission proposals in Article 22, 2 (l), FEE suggests highlighting even further that the auditor is required to provide a statement on *management's assessment* and disclosure of the audited entity's ability to meet its obligation in the foreseeable future and therefore continue as a going concern.** This should help mitigate the risk of widening users' expectation gap regarding the auditor's work on going concern assumptions.

An example on how the disclosures in the audit report could be displayed is set out below. This example is only indicative and iterative as it is expected to be subject to much debate and refinement:

Example of auditor disclosure on going concern assumptions in the audit report:

"As part of our audit of the financial statements, we have concluded that management's use of the going concern assumption is appropriate.

Based on the audit evidence we have obtained, we have not identified material uncertainties related to events or conditions not already disclosed in the financial statements that may cast significant doubt on the entity's ability to continue as a going concern and we have not proposed any changes be made to the disclosures included in the financial statements regarding going concern.

However, future events or conditions may change the assumptions that this statement is based upon and therefore may also affect the entity's ability to continue as going concern".

Audit approach

The audit report should be more entity specific. This could be done by providing information on the audit approach for that specific entity, including commenting on significant audit risks that the auditor has identified and addressed during the audit. At the beginning of the audit, the auditor identifies areas that appear to be significant audit risks. This enables the auditor to focus the audit work on those areas where the risk of material misstatement of the financial statements is the highest. These significant audit risk areas may need to be readjusted as the audit work evolves. Significant audit risks will relate to various items in the financial statements and could for instance be related to revenue recognition, use of fair value measurements including measurement of financial instruments, sovereign debt exposures, etc.

Under the current framework for audit reports, auditor comments on specific items in the financial statements can risk giving the impression that an auditor expresses piecemeal audit opinions. In order to maintain the clear pass/fail nature of the audit report, it will be essential to clearly specify in the audit report which significant audit risks the auditor has identified and – without expressing an individual opinion on individual areas of significant risk - provide users with clear information about the work done on each of these specific areas in support of the overall audit opinion on the financial statements as a whole. In this way, misconceptions about piecemeal audit opinions on parts of the financial statements could be mitigated.

Audit work based on ISAs already addresses potential fraud risks. Such risks exist in all entities and can never be removed completely but can be mitigated by performing audit procedures that respond to the fraud risks identified. Although fraud risks are significant risks from an ISA audit perspective, the fraud risks in a particular entity might turn out to be low. Therefore, there would be little merit in including them as significant audit risks in the audit report of this particular entity.

Based on this, FEE proposes to simplify and make the European Commission proposals on describing the audit methodology used more practical. **This could be done by replacing the European Commission proposals to report on matters related to "*methodology*" with reporting on matters related to "*audit approach*" and "*significant audit risks*", replacing and merging Article 22 paragraphs 2 (h), (i), (k), (m) and (n).** In practice, details regarding audit work performed to address specific significant audit risks identified during the audit of the entity in question are more useful than a generic description of the audit approach.

The number of significant audit risks will vary from one audit to another. In less complex audits, there may be only one significant audit risk, but in audits of more complex entities with complex business models, more significant audit risks could be expected to be identified.

Examples of how the auditor might comment on significant audit risks in the audit report follow. These examples are only indicative and iterative as they are expected to be subject to much debate and refinement:

Examples of auditor disclosure on significant audit risks in the audit report:

Example 1: Sovereign Debt

The accounting estimates used in the preparation of the financial statements as per 31 December 2011 were made in a context of uncertainty arising from the sovereign debt crisis in some Eurozone countries.

This has led to lack of visibility concerning economic prospects and to volatility in financial markets during 2011, details of which are provided in note 15 regarding sovereign debt exposures (in total € 53 billion) in some Eurozone countries.

We have tested the control procedures implemented to measure such exposures and to assess the credit risk associated with these exposures. The test of controls was supplemented by substantive audit procedures to confirm that items were appropriately recorded and measured. Based on the results of this audit work, we did not propose any adjustment be made to the control procedures used, the recording of impairment and write downs by the company or the disclosures provided in note 15.

Example 2: Revenue Recognition
On a transaction basis, the group recognises revenue in full on receipt of cash. A deferred income adjustment is then calculated to take account of subscription payments received in advance.

Our audit work was designed and performed in order to assess the adequacy of the systems and controls in place for recognising revenue and to substantively review revenue recognised during the year using IT based audit techniques. This included reconciling revenue recognised to cash received and an assessment of compliance, or otherwise, with IAS 18 on Revenue. As a result of our audit procedures, audit adjustments were identified and recorded in the financial statements to ensure that revenue is recognised evenly over the subscription period.

Based on the audit work performed, we did not propose that further adjustment be made to revenue recognition as reflected in the statement of comprehensive income.

Example 3: Valuation of Investment Properties
In the statement of financial position as at 31 December 2011 the carrying amount of Investment Properties is € 238 million. There is continued uncertainty in the commercial property market and as a result commercial property values have fallen by varying levels in various locations. Movement in these revaluations could result in potential losses for the company and the group. Therefore, we identified this area as a significant risk for our audit and performed specific audit procedures. As stated in note 18, the investment properties were written off by € 22 million as at 31 December 2011.

The audit work performed included detailed testing of the valuations carried out by management. This involved testing the assumptions made by management and corroborating these with comparable data in the industry.

Based on this work, we did not propose any adjustment be made to the valuation of investment properties or the disclosures provided in note 18.

Although not proposed by the European Commission, FEE proposes that the auditor provides additional information to the audit committee regarding the audit approach and identified significant audit risks. This would also include more details regarding the concept of materiality and the audit procedures performed on the significant audit areas.

Internal controls

Reporting on deficiencies in internal controls within the entity as identified during the audit is more relevant to management and to the audit committee than to the public. Management is responsible for the internal control systems and thus they need to understand where deficiencies have arisen so that they can develop action plans to mitigate these deficiencies.

The information needs of users of audit reports should focus on understanding whether any significant deficiencies in internal financial controls identified by management and/or the auditor have been resolved (or not) and whether they have impacted the audit work performed.

The European Commission proposals for disclosures regarding internal control deficiencies in the audit report would require the auditor to assess the internal control system. This would involve significantly increased costs for entities to document all their internal control procedures and significantly increased work for auditors to audit them to be able to assess their effectiveness. Such requirements appear to add little value. For instance, Section 404 of the Sarbanes-Oxley Act (SOX) in the US did not prevent the financial crisis. The current risk-based audit approach forms the basis for communication of deficiencies in internal control that the auditor has identified during the audit of the financial statements. This is in our view sufficient and incorporating a SOX approach in European legislation should be avoided.

To mitigate this misunderstanding, **FEE suggests that the following is explicitly required to be reported by the auditor in the audit report: "*Significant internal control deficiencies <u>in relation to the financial reporting process</u> including bookkeeping and accounting systems identified during the statutory audit of the entity, where relevant to significant risks*" instead of the European Commission proposal in Article 22, 2 (m).**

Information on deficiencies in internal control in the internal report will be of benefit to the audit committee in discharging its monitoring responsibilities of the audit and of internal control in general. This is already required under the current Statutory Audit Directive and by ISA 265.

Other issues

A few additional issues brought up by the European Commission regarding auditor communication have attracted some attention. Among these are for instance the proposal to identify each member of the entire engagement team in the audit report (Article 22, 2 (q)) and the requirement regarding the length of the audit report of maximum 10.000 characters or 4 pages long (Article 22, 2 (u)). Such disclosures and prescriptive requirements appear disproportionate and neither necessary nor appropriate.

About FEE

FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.