FEE Federation of European Accountants
Fédération des Experts comptables Européens

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.