European Securities and Markets Authority

The Chairman

Date: 20 October 2011
ESMA/2011/353

Arnold Schilder
IAASB Chairman
545 Fifth Avenue, 14th Floor
New York 10017
United States of America

RE: IAASB Consultation Paper – Enhancing the Value of Auditor Reporting: Exploring Options for Change

Dear Mr Schilder,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to safeguarding the stability of the European Union's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as by enhancing investor protection.

ESMA has considered, through its Standing Committee on Corporate Reporting, the Consultation Paper issued by the IAASB: Enhancing the Value of Auditor Reporting: Exploring Options for change (the "CP") and is pleased to provide you with the following general comments:

- Calls for changes in the auditor reporting have been raised by various stakeholders and particularly by investors because of the perception of the so called "information gap". We appreciate IAASB efforts to explore ways to improve auditor reporting in order to better meet investors' needs and we are in favour of improved transparency on the audit. However, while we recognize the potential benefits of a more "narrative" audit report that would enable a better understanding of the auditor's work effort and of the key judgements and conclusions relevant to that specific audit, we would caution on changes in the auditor's mandate that would lead to ask auditors to give information that should, more appropriately, be given by management and those charged with governance. It is important not to create potential for confusion among different roles and responsibilities and in this regard we believe that auditors' role should continue to be to provide assurance on information provided by the company.
- There could be benefits in auditors providing some form of assurance beyond the audit of financial statements. However any extension of the auditor's mandate on information beyond the financial statements should be carefully considered taking into account the level of assurance that can reasonably be provided by auditors (considering also the risk of an increase in the expectations gap)

and the existence of standards and principles as appropriate points of reference for those who prepare the information and for the auditors.

- Auditor reporting, notwithstanding its importance, is only one element of the broader corporate financial reporting process which depends on the legal and regulatory environment, and on the decisions of management and those charged with governance. To achieve high-quality corporate reporting considerations should also be given to these other factors. In broadest terms it is important to explore ways for enhanced corporate reporting models.
- Our focus is on securities markets and therefore the views expressed in this letter are relevant to audits of listed companies.

Our detailed comments on the CP are set out in the Appendix to this letter. I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Steven Maijoor,
Chair ESMA

APPENDIX – ESMA's detailed answers to the questions in the IAASB's Consultation Paper (CP): Enhancing the Value of Auditor Reporting: Exploring Options for Change

Section A: Issued identified

Question1: Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?

Question 2: If respondents believe changes in auditor reporting are needed, what are the most critical issues to be addressed to narrow the information gap perceived by users or to improve the communicative value of auditor reporting? Which classes of users are, in the view of respondents, most affected by these issues? Are there any classes of users that respondents believe are unaffected by these issues?

Question 3: Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities?

1. ESMA's focus is on the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection in such markets. As such, ESMA's comments in this letter are in the context of audits of listed entities.

2. Overall ESMA acknowledges the issues regarding the perception of auditor reporting today, particularly in the context of listed entities, and in the increasingly global and complex business environment. The "expectations gap" has evolved over time but it still exists and we appreciate the IAASB's efforts in trying to address users' needs. Section II of the CP sets out a useful description of the issues relating to auditor reporting currently. In particular, the distinct concepts of 'expectation gaps' and 'information gaps' are a useful way to think about the issues regarding auditor reporting and how the gaps could be reduced. ESMA believes that changes in auditor reporting are needed to allow for greater information to be provided by the auditor than is currently the case.

3. That said ESMA believes that calls for changes should be carefully evaluated and that some pivotal points of the current context cannot be changed. In this regard ESMA believes that the division of responsibility between an entity's management and its auditor is important and should not be blurred. Information gaps primarily relate to shortfalls in information provided by management (for example in financial reporting disclosure). In such circumstances it is management's responsibility to bridge the gap, as it is management that is responsible for presenting a true and fair view of the entity, and auditors responsibility to express an opinion thereon. The CP raises a valid concern about the risks where the auditor *originates* information about the entity rather than management. However there is likely to be benefit in the auditor providing some form of assurance over disclosures made by management outside of the audited financial statements.

4. Expectation gaps relate to the gap between (i) the work that an auditor does and the aim of that work, and (ii) what others perceive that the auditor does. For example, the aim of the audit is not to provide a guarantee on financial health of companies or some form of 'early warning system' about an entity's future performance or viability, but some may have that expectation. There are merits in addressing this gap through an expanded audit report – for example by describing the work of the auditor in respect of going concern, fraud or other key areas of risk– but there is clearly a risk of additional 'boilerplate' text in the audit report, which would not be helpful.

5. More comments on the points raised above are provided in our answers to the following detailed questions.

Question 4: Respondents are asked for their reactions to the options for change regarding the format and structure of the standard auditor's report described in Part A. Do respondents have comments about how the options might be reflected in the standard auditor's report in the way outlined in Appendix 1 of this Consultation Paper?

Question 5: If the paragraphs in the current standard auditor's report dealing with management and the auditor's responsibilities were removed or re-positioned, might that have the unintended consequence of widening the expectations gap? Do respondents have a view regarding whether the content of these paragraphs should be expanded?

6. In general, ESMA supports considering the format and structure of the standard auditor's report. ESMA is of the view that the auditor's report should clearly state the responsibilities and the outcomes of the auditor's work. Further, ESMA thinks that an auditor's report should be informative to users, and therefore, that information in the auditor's report should be concise and specific to the audit and the company, and that the use of boiler plate language should be avoided where possible.

Explanations of Management and Auditor Responsibilities

7. As stated above, ESMA believes that the explanations of management's and auditor's responsibilities form an integral part of the auditor's report and should not be removed from the body of the report. In order to keep the report informative, ESMA would suggest to include also further information clarifying and specifying the auditor's responsibilities regarding other information that goes with the audited financial statements. ESMA believes that this could contribute to reducing the expectations gap (please refer also to our comments under questions 6 and 7).

8. As regards the current second paragraph under auditor's responsibility, the aim of which is to explain the main features of the audit procedures performed in order to come to an audit opinion, ESMA believes that the current language is boilerplate text and as such of little use to investors. ESMA. Therefore believes that this text should be more entity-specific and included in the proposed Auditor's Commentary paragraph; the paragraph should explain risks identified and procedures per-

formed to address these risks (please refer also to our comments under the questions on Auditor Commentary). ESMA does not support moving this paragraph into an annex or anywhere below the signature of the auditor's report. ESMA believes that this could make the status of this text very unclear to users, which may result in widening the expectations gap.

9. The third paragraph under auditor's responsibility contains the statement that the auditor has obtained sufficient and appropriate audit evidence to support his opinion. ESMA considers this paragraph as a fundamental part of the opinion. ESMA therefore proposes to relocate this sentence near to the opinion paragraph in the report, instead of its current location as part of the auditor's responsibilities.

Use of Technical Language

10. ESMA agrees that the current use of technical language in the auditor's report impairs the understandability of the report by users, as these may have different meanings, especially when translated. However, this cannot be easily resolved within the context of the auditor's report. ESMA therefore suggests that IFAC and its members embark on a project aimed at improving a more consistent understanding of these terms. Further, ESMA believes that making the auditor's report more entity-specific, especially the Auditor's Commentary paragraph, will also contribute to an increased understanding of these technical terms.

Location of the Auditor's Opinion

11. ESMA agrees with the suggestion to give the opinion more prominence by moving it to the first part of the auditor's report.

Question 6: Respondents are asked for their reactions to the possibility that the standard auditor's report could include a statement about the auditor's responsibilities regarding other information in documents containing audited financial statements. Do respondents believe that such a change would be of benefit to users?

Question 7: If yes, what form should that statement take? Is it sufficient for the auditor to describe the auditor's responsibilities for other information in documents containing audited financial statements? Should there be an explicit statement as to whether the auditor has anything to report with respect to the other information?

12. ESMA is of the view that a statement in the standard auditor's report about the auditor's responsibilities regarding other information in documents containing audited financial statements could be of benefit to users. Currently ISA 720 requires auditors to "read" the other information to identify material inconsistencies with the audited financial statements but this work is not necessarily reflected in the auditor's report, even when the other information is obtained prior to the date of the auditor's

report. Indeed the aim of ISA 720 appears to be currently different from what could be envisaged under a broader approach where the work already done by auditors under ISA 720 could also be of benefit for users. In a new approach the visible output of the work done by the auditor will also add clarity to the performance of the work itself.

13. ESMA believes that auditors could play an important role in this respect because of the knowledge and expertise obtained through the audit work on the company's financial statements. Using their audit knowledge as a background they can read documents containing audited financial statements with a critical mind and appropriate skepticism. In a new approach the level of the work effort can be raised, however the nature and extent of the work that can be expected from auditors depends on how much the "other information" is linked and interrelated with the financial statements and the processes behind. The more strong the linkages the more the added value that can derive from auditors' consideration of this "other information".

14. Additional challenges in developing a possible statement regarding other information are in the identification of the information itself. The current definition of other information in ISA 720 includes a variety of documents provided by the management, with a very different content. The nature of other information and the relevant management responsibilities (and eventually auditors responsibilities) vary because of the different laws applicable in various jurisdictions. Therefore it could be challenging to develop common standards at international level applicable to most of this information. Nevertheless ESMA believes that broad principles or a common background could be developed, which could also act as a driver for guidance on jurisdiction-specific situations where necessary.

15. An important element of financial reporting that deserves attention in respect of the above is the Management Discussion and Analysis (MD&A). In Europe the Directive 78/660/EEC requires auditors to express an opinion concerning the consistency or otherwise of the annual report with the financial statements and requires that the audit report includes this opinion. Moreover, according to the Directive 2006/46/CE, for companies whose securities are admitted to trading on a regulated market, the opinion on the consistency should also cover the description of the main features of the company's internal control and risk management systems in relation to the financial reporting process, provided by the management in a specific section of the annual report. There are different practices in Europe with regard to the output of this work in the audit report, and it could be worth exploring the feasibility of a common approach. As regards the consistency check, the work effort in ISA 720 could be clarified and reinforced, given its importance particularly for the MD&A.

Section C. Auditor Commentary on Matters Significant to Users' Understanding of the Audited Financial Statements, or of the Audit

Question 8: Respondents are asked for their views regarding the auditor providing additional information about the audit in the auditor's report on the financial statements.

16. ESMA is supportive of more value added information in the audit report with regard to the audit process. However to be really of value the increased information should not be generic but tailored on the specific circumstances and challenges faced by the auditor in issuing that specific audit report. In developing new approaches it is important to avoid the risk that additional "boiler-plate" text is included in the audit report. By the same token is also important to consider the risk of different level of information provided by auditors in substantially equivalent or very similar situations, with a negative impact on the comparability of auditors reports, thereby giving misleading messages to users and widening the gap instead of reducing it.

17. The CP in paragraph 62 provides some examples of increased information that could be included under the Auditor Commentary. Amongst others the CP mentions "key areas of risk of material misstatement of the financial statements identified by the auditor, including critical accounting estimates or areas of measurement uncertainty in the financial statements", "areas of significant auditor judgement, for example, judgements about material uncertainties that may cast doubt about an entity's ability to continue as a going concern, or judgements pertaining to the recognition, derecognition, measurement or disclosure of relevant items within the financial statements" and "areas of significant difficulty encountered during the audit and their resolution". As said, we are in favour of more transparency about the audit work and the relevant findings and some of the above elements can be considered in this regard. However it is important to avoid the risk that information included in the Auditor Commentary could represent a way to disguise qualifications or lack of adequate disclosure from management. Disclosure on accounting estimates, uncertainties, and going concern is to be provided by management in compliance with the accounting rules and auditors should verify that the disclosure provided in the financial statements is appropriate to show the "true and fair view". We believe that in order to meet investors needs, high quality audit work about disclosure is extremely important and we encourage the IAASB to work on this area (as we set out in our comment letter on the IAASB's recent consultation paper on the audit of disclosures).

18. Other examples of information mentioned in the CP relate to "the entity's internal controls, including significant internal control deficiencies identified by the auditor during the audit". Information about the entity's internal controls should be given by management as part of the corporate governance reporting. On significant internal control deficiencies (in this context presumably overcome by the auditor) the difficulties of providing concise and comprehensible information in the audit report, and the risk of blurring the boundaries between the responsibilities of management and auditors, seems to outweigh the potential benefits for investors. We believe that it would be more appropriate for auditors to report and discuss these topics with management and audit committees rather that proving information thereof in the audit report. Therefore enhancing communications between auditors and audit committees in this regard, especially for listed entities would be more effective.

There may be benefit in considering whether audit committees could then provide such disclosures, considering also their responsibilities on the above. Greater transparency by audit committees about the matters they have considered during the year (including discussions with auditors) could enhance corporate governance reporting and help to address the information gap (please refer also to paragraphs 26 and 27).

19. About the other issues raised in the CP on the use of ISA 706 we agree that it could be of benefit to encourage auditors to use the "emphasis of matter" and the "other matter" paragraphs as described in ISA 706, within the rules established in this standard. We also encourage the IAASB to clarify the appropriate use of these paragraphs in order to avoid possible misunderstandings.

Question 9: Respondents are asked for their reactions to the example of use of justification of assessments in France, as a way to provide additional auditor commentary.

20. We encourage the IAASB to consider experiences in other countries and whether or not they have contributed to meet some of the needs raised by stakeholders.

Question 10: Respondents are asked for their reactions to the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor's report.

21. ESMA believes that any consideration on the prospect above should be based on the premise that it is important not to create potential for confusion among different roles and responsibilities. The role played by auditors is very different from the one played by management and, in broadest terms, by those charged with governance. Therefore the auditor should not take responsibility for disclosure of information about the entity when management and others are in the best position to provide this information to the public, and must retain primary responsibility for communications with stakeholders.

22. Any request to auditors should follow a request to management or those charged with governance to produce the relevant information on which auditors could then be asked to perform an assurance work. In addition to this, the work can be done where principles and standards exist as appropriate point of reference for both preparers and auditors.

23. Auditors reporting on matters that are not disclosed by the entity raises concerns for a number of reasons, including, for example, possible situations where competing disclosures about the entity from management and the auditor will create confusion and misunderstandings among users, or po-

tential conflicts with regard to law and regulation concerning confidentiality. In addition to this we believe that such a level of involvement could also bring threats to auditor independence.

24. The IAASB consultation paper in paragraph 72 highlights that there have been calls for auditors to share insights and perceptions about the entity or the quality of its financial reporting, based on the work done for the financial statements audit. The following areas of interest have been identified in the paper:
    - The quality of the entity's internal controls and financial reporting processes
    - Qualitative aspects of the entity's accounting policies, including the relative conservatism or aggressiveness reflected in management's selected policies
    - The auditor's assessment of management's critical accounting judgements and estimates, including where each critical judgement or estimate falls within a range of possible results
    - The quality and effectiveness of the entity's governance structure and risk management, and the quality and effectiveness of its management.

25. We believe that auditors role should not entail sharing insights and perceptions on the above mentioned matters. More information could be provided by auditors along the lines already described in our response to question 8.

Section D. An Enhanced Corporate Governance Model: Role of Those Charged with Governance regarding Financial Reporting and the External Audit

Question 11

Respondents are asked for their reactions to the options for change relating to an enhanced model of corporate governance reporting, as described in Section III, Part D.

Question 12

To the extent that respondents support this model, what challenges may be faced in promoting its acceptance? Also, what actions may be necessary to influence acceptance or adoption of this model, for example, by those responsible for regulating the financial reporting process?

Question 13

Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?

26. As described in the response to questions above, ESMA believes that information about the entity should come from management, not the auditor. Enhanced corporate governance reporting could

help to address the information gap. It could include reporting matters of interest to investors, such as the degree of aggression in accounting choices, risk positions and key judgements and estimations underlying the financial information; these are some of the areas that could be usefully reported through enhanced corporate governance reporting. This could include a requirement to explain how management has complied with accounting standards in arriving at a true and fair view.

27. Some form of auditor assurance over enhanced corporate governance reporting could help to engender discussion between the auditor and management regarding the disclosure of information that would be useful to investors, and would provide investors with a greater degree of confidence in the information being disclosed. For these reasons, ESMA believes that it would be worth exploring auditor assurance over corporate governance reporting.

Section E. Other Assurance or Related Services on Information Not Within the Current Scope of the Financial Statement Audit

Question 14

Respondents are asked for their reactions to the need for, or potential value of, assurance or related services on the type of information discussed in Section III, Part E.

Question 15

What actions are necessary to influence further development of such assurance or related services?

28. In Europe, there are currently different practices in different countries regarding the auditors mandate on providing assurance on the following non-financial statement subject matters, indicated as examples in paragraph 88 of the Consultation Paper:

- Corporate governance arrangements;
- Business model, including the sustainability thereof;
- Enterprise-wide risk management;
- Internal controls and financial reporting processes; and
- Key performance indicators.

The practices are based on the national law in each country. Some of those areas have been subject to discussion, e.g. corporate governance for which the European Commission has launched recently a Green Paper and it might be subject to further proposals for harmonisation in Europe.

29. Consequently, at this stage, in the absence of a harmonised approach over the form and content of reports to be prepared by the companies, we believe there are challenges in the IAASB exploring issuance of standards on the type of assurance auditors could provide on such reports. Nevertheless, as set out in our response to question 13 above, we believe this is an area worth exploring. We also encourage the IAASB to monitor developments which might come up in the future on these subject matters.