European Securities and Markets Authority

The Chair

Date: 20 December 2012
ESMA/2012/ESMA/849

Arnold Schilder
IAASB Chairman
545 Fifth Avenue, 14th Floor
New York 10017
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Re: IAASB Invitation to Comment – Improving the Auditor's Report

Dear Arnold,

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 welcomes the opportunity to consider the Invitation to Comment issued by the IAASB: *Improving the Auditor's Report* (the "ITC"). ESMA appreciates the IAASB's efforts to explore ways to improve auditor reporting in order to better meet investors' needs and is in favour of improved transparency with respect to auditor reporting. The views expressed in this letter are made from the point of view of securities regulators with the aim to enhance investors' protection and with an interest in the quality of listed entities' auditors' reports.

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

The auditor's report should continue to include a clear opinion on whether the financial statements give a true and fair view, but it should also clearly communicate the views of the auditor on specific items in the financial statements as well as the audit process undertaken when the opinion is qualified or when there is an emphasis of matter. These elements could be supported by additional information to be provided by the auditor regarding his views on management judgements.

We believe that the elements proposed in the Auditor Commentary constitute enhancements when they describe substantive issues the audited entity is facing and the results of the auditor's assessment of the key judgements made by management rather than being descriptive in nature and only referring back to the financial statements. Consequently, items included in the Auditor Commentary should be as specific to the audit of the entity as possible and should not contain any repetitive disclosures or boilerplate language.

ESMA supports the general direction of the proposed changes, but is concerned that some of these changes might have an adverse impact on understanding the role of the auditor and might widen rather than narrow the expectations gap, as further explained in the answer to question 5. Some of the elements of the proposed auditor reporting might lead to blurring the responsibilities of management and the auditor. ESMA would not support such changes to the auditor's report that would require auditors to provide information that should be given by management or those charged with governance.

Auditors' reporting on going concern is of crucial importance for investors. While supporting the explicit reference to the assessment of going concern, further consideration should be given to a more entity specific going concern assessment in the auditor's report. Even if it could appear beyond the scope of this ITC, ESMA would encourage the IAASB to work further on this issue in close cooperation with the International Accounting Standard Board ("IASB") and provide a more detailed guidance related to the entire concept of going concern.

ESMA is concerned about the IAASB's preliminary view that the concept of Emphasis of Matter could be replaced by a new approach whereby auditors can report in the Auditors Commentary matters which are likely to be most important to users' understanding of the financial statements. We believe that the Emphasis of Matter paragraph should be retained as it focuses on issues fundamental to users' understanding of financial statements and should be distinguished from the Auditor Commentary by its content as well as its location in the auditor's report.

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. Although beyond the scope of this ITC, ESMA encourages the IAASB to explore ways for enhanced corporate reporting models in their broadest terms.

Finally, in order to ensure global consistency of auditor's reporting, ESMA would encourage the IAASB to closely monitor the current work being done by the European Commission and the Public Company Accounting Oversight Board (PCAOB) regarding the content of the auditor's report.

Our detailed comments on the ITC 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 Invitation to Comment (ITC): Improving the Auditor's Report

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, comments in this letter are in the context of audits of listed entities.

Overall Considerations

Question 1: Overall, do you believe the IAASB's suggested improvements sufficiently enhance the relevance and informational value of the auditor's report, in view of possible impediments (including costs)? Why or why not?

Question 2: Are there other alternatives to improve the auditor's report, or auditor reporting more broadly, that should be further considered by the IAASB, either alone or in coordination with others? Please explain your answer.

2. Overall, ESMA welcomes the suggested improvements in the content and format of the auditor's report. The proposed changes to the structure and content of the auditor's report are a step in the right direction that will enhance the relevance and informational value of the auditor's report and will contribute to enhance perception of auditor reporting.

3. The proposed auditor reporting will bring a higher degree of transparency to audit process thus contributing to increased responsibility and enhanced accountability of the auditor. Providing more information by the auditor than is today the case is essential for reducing the 'expectations gap' and the 'information gap'. That said, some of the proposed changes, notably in relation to 'other information, as further discussed in response to question 10, might not lead to narrowing the expectations gap, but rather might widen it.

4. The division of responsibility between an entity's management and its auditor is an important feature of the auditor reporting and should not be blurred. It is management's responsibility to provide all relevant information as required by the IFRS (or other applicable financial reporting framework), as it is management that is responsible for presenting a true and fair view of the financial performance and financial position of an entity. It is the auditor's responsibility to express an opinion thereon. As further elaborated in the response to Question 5, examples in the Auditor Commentary section of the "Illustration of a possible improved auditor's report" might lead to blurring the line between management and auditor's responsibility.

5. Providing more narrative information in the auditor report in the form of Auditor Commentary enhances the value of the auditor report for the users but should be formulated in a way that it cannot be seen as providing information that should have been provided by the management.

6. To clarify the content of the Auditor Commentary, ESMA would encourage the IAASB to work together with the IASB to improve disclosures in the financial statements, to avoid auditor's report providing information about the entity, which is not already disclosed by management in the financial statements.

7. While supporting the concept of Auditor Commentary, ESMA sees value in retaining the concept of Emphasis of Matter to preserve the informational value that paragraph brings to investors. The value of the Emphasis of Matter paragraph lies in drawing users' attention to matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements. By subsuming the concept of Emphasis of Matter to the broader concept of Auditor Commentary, the message of pointing out specific fundamental item might be lost. Users might not be alerted by one of several items of Auditor Commentary in the same way as by a single paragraph of Emphasis of Matter as defined in ISA 706 - *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. By retaining the concept of Emphasis of Matter, auditor can more properly communicate the matters that are fundamental to users' understanding of the financial statements.

8. Retaining the concept of Emphasis of Matter would require clarification of appropriate use of Emphasis of Matter and Auditor Commentary to avoid possible misunderstandings. ESMA would encourage the IAASB to clearly stipulate enforceable principles and criteria for the usage of Emphasis of Matter paragraph and Auditor Commentary. ESMA is of the view that Emphasis of Matter shall include only the most critical matters where users of financial statements need to consider matters subject to significant risks. On the other hand, Auditor Commentary should provide transparency to the auditor reasoning and judgments that were used in the audit process. Once the auditor includes an item in an Emphasis of Matter paragraph, that matter should not be repeated again in the Auditor Commentary.

9. The value of the unambiguous opinion of the auditor on the financial statements shall not be devalued as that is appreciated by users of financial statements. Consequently, ESMA supports the emphasis the proposal put on the "Opinion" as first paragraph of the auditor's report. At the same time, the concept of Auditor Commentary should be defined in a way as not to devalue the 'clean opinion' in the eyes of the users.

10. As stated in ESMA's Comment letter on the IAASB Consultation paper – *Enhancing the Value of Auditor Reporting: Exploring Options for Change,* ESMA believes that it would be worth exploring auditor assurance over corporate governance reporting or other non-financial statements subject matters, even if those are currently beyond the scope of the ITC.

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

Section: Auditor Commentary

Question 3: Do you believe the concept of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report? Why or why not? (See paragraphs 35–64.)

Question 4: Do you agree that the matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, with guidance in the standards to inform the auditor's judgment? Why or why not? If not, what do you believe should be done to further facilitate the auditor's decision-making process in selecting the matters to include in Auditor Commentary? (See paragraphs 43–50.)

12. The proposed Auditor Commentary concept will provide transparency about the matters that are likely to be the most important to users' understanding of the audit process and audited financial statements by providing information about significant management judgements and its assessment by the auditor as well as by providing an insight into the audit process of the entity. It will be a useful way to provide more information to users and link the judgements made by the management and the auditor thus narrowing the expectations and information gaps.

13. The value of Auditor Commentary is enhanced when it describes real issues the audited entity is facing and the results of the auditor's assessment of the key judgements made by the management rather than being descriptive in nature and only referring back to the financial statements. Consequently, items included in the Auditor Commentary should be as specific to the audit of the entity as possible and should not contain any repetitive disclosures or boilerplate language. In order to fulfil its purpose, when auditor's procedures are described, results of these procedures need to be disclosed and assessed.

14. ESMA agrees with the overall objective of the Auditor Commentary section as described in paragraph 39 of the ITC, however, as further elaborated in our answer on Question 5, ESMA is concerned that some of the examples suggested in illustration of the auditor's report might lead to confusion. The concept of Auditor Commentary requires more specific guidance in the standards and should include clear purpose of the Auditor Commentary as well as high-level principles and illustrative examples to guide auditor's judgement, including specific criteria to help make the judgement.

15. The ITC specifies that the Auditor Commentary shall include at minimum areas of significant management judgement, significant or unusual transactions and matters of audit significance. ESMA agrees with this scope but would suggest that the Auditor Commentary includes also areas issues related to the audit as e.g. judgments applied and considerations given to determination of the level of

materiality used for audit procedures or assessment of risks and explicit auditor assessment whether management estimates are on the higher/lower end of the range of outcomes. Given the significant change of the content and format of the Auditor's report, IAASB might consider further steps to enhance education of users regarding the meaning of Auditor Commentary and understanding the new content and structure of the Auditor's report.

Question 5: Do the illustrative examples of Auditor Commentary have the informational or decision-making value users seek? Why or why not? If not, what aspects are not valuable, or what is missing? Specifically, what are your views about including a description of audit procedures and related results in Auditor Commentary? (See paragraphs 58–61.)

16. In general, illustrative examples are important an part of the proposals and when included in the final standard could provide auditors and users a valuable insight about the audit process. That said currently provided illustrative examples could be further improved.

17. Repeating the disclosures by simply referencing to a note of the financial statements as is the case in the first example is of little informational value to the users of auditor's report. Without putting the disclosure into an additional context (e.g. by providing the results of audit procedures or explaining the fundamental importance of the issue), such example increases the risk of boilerplate paragraphs in the auditor's report that will only point to disclosures already provided in the financial statements by the management.

18. In this example it is not clear why the auditor points out to a disclosure in line with the applicable financial reporting framework which is already provided by the management in the financial statements. If the auditor's intention is to highlight the disclosure due to its fundamental value to the users, as currently required in the Emphasis of Matter paragraph by ISA 706, that could be improved by retaining the concept of Emphasis of Matter and including this information within that paragraph.

19. The second example included has also limited informational value for the users who would expect this disclosure to be provided by the management of the entity in the financial statements rather than by the auditor in the auditor's report. ESMA would expect a greater focus on assessment of the management procedures and estimates rather than providing information already disclosed in the financial statements which is in line with the requirements of the respective financial reporting framework. In order to be useful, the Auditor Commentary needs to include the results of the auditor's procedures on the goodwill impairment test and their assessment.

20. The third example contains better informational value for the users as it provides the results of the auditor's procedures and assessment of the management estimates by the auditor. Nonetheless, the

example could include more information on why the judgements made by the management were accepted by the auditor.

21. Although entity-specific information related to audit scope and audit strategy in Auditor Commentary might provide additional information to users, it also raises the difficulties in the overall understanding of the auditor's report. The IAASB might consider including the results of the audit strategy and procedures in the Audit Commentary, but more comprehensive reporting on audit strategy and its results should be included in the report addressed to the Audit Committee.

22. ESMA welcomes including examples about the '*Involvement of Other Auditors*'. This paragraph can inform readers of financial statements who could make their judgement about the audit performed by the Group auditor and auditors of the component entities. For more details please refer to ESMA's response to Question 13.

Question 6: What are the implications for the financial reporting process of including Auditor Commentary in the auditor's report, including implications for the roles of management and those charged with governance (TCWG), the timing of financial statements, and costs? (See paragraphs 38 and 62–64.)

Question 7: Do you agree that providing Auditor Commentary for certain audits (e.g., audits of public interest entities (PIEs)), and leaving its inclusion to the discretion of the auditor for other audits is appropriate? Why or why not? If not, what other criteria might be used for determining the audits for which Auditor Commentary should be provided? (See paragraphs 51–56.)

23. ESMA agrees with the mandatory provision of the Auditor Commentary for the audit of certain entities. In line with its focus on integrity of securities markets, additional value of the Auditor Commentary can be seen for the public interest entities. As proposed in the ITC, either public listed or public interest entities are the appropriate criteria for mandating the Auditor Commentary.

24. For other entities, it should be left to the discretion of the auditor and/or the local legislator/regulator to decide whether to include Auditor Commentary in the auditor's report. In line with the objective of the Auditor Commentary, the criteria for including that shall be based on its perceived informational value and if it would provide additional transparency to the users. National regulators, based on national market needs, might mandate including Auditor Commentary for audits of non-public interest entities. However, the IAASB needs to clearly communicate to the users that the underlying audit is the same ("an audit is an audit") and that Auditor Commentary relates only to the extra reporting requirements rather than differences in the audit methodology and/or process.

25. ESMA would assume that the auditor will provide management and those charged with governance a draft of the auditor's report, including the Auditor Commentary, and this may result in the latter wishing to include additional information in the financial statements, which would also be beneficial for the users of the financial statements.

Section: Going Concern/Other Information

Question 8: What are your views on the value and impediments of the suggested auditor statements related to going concern, which address the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified? Do you believe these statements provide useful information and are appropriate? Why or why not? (See paragraphs 24–34.)

Question 9: What are your views on the value and impediments of including additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statement that no material uncertainties have been identified? (See paragraphs 30–31.)

26. The financial crisis shows that auditors shall play a more important role in the assessment of the going concern assumption. While suggested auditors statements addressing the appropriateness of the management's use of the going concern assumption and identification of material uncertainties are helpful, ESMA would prefer a more entity specific assessment of the management assumptions of going concern in the auditor's report. In addition, ESMA is concerned about the last sentence of the '*Material uncertainties…*' paragraph of the illustrated auditor's report that seems to lead to possible misunderstanding and would rather avoid it. Explicit statement that not all future events or conditions can be predicted and that the statement is not a guarantee of the ability of the company to continue as a going concern is a boilerplate disclaimer that can lead to confusion and can raise doubts about the statements included immediately before.

27. ESMA is concerned that without greater focus on entity specific information, the suggested section related to going concern might become boilerplate and would decrease the value of such paragraph to users of the Auditor's report.

28. While recognising that explicit auditor conclusion on the entity's future viability goes beyond the current scope of an audit, there might be other ways to strengthen the specificity of the auditor conclusion on the management use of going concern assumption. For example, one of the recommendations of the recently issued Sharman report suggested including "*an explicit statement in the auditor's report as to whether the auditor has anything to add to or emphasise in relation to the disclosures made by the directors about the robustness of the process and its outcome, having considered*

the directors' going concern assessment process". ESMA would see merit in considering such recommendation in providing more entity specific assessment on going concern in the auditor's report.

29. ESMA would also support providing additional information by the auditor in case no material uncertainty exists, but certain events have been identified that may cast significant doubt on the entity's ability to continue as a going concern. Additional information regarding the auditor's assessment of the going concern assumption could reduce the expectation gap.

30. It might be helpful that the audit process undertaken in respect of the assessment of going concern is clearly described as part of the going concern section of the auditor report. Nonetheless, any such description of responsibilities should be entity specific and shall avoid boilerplate language that has limited value for the users of the auditor report.

31. Although going beyond the current ITC, ESMA supports the IAASB efforts to provide a more holistic approach to going concern. In particular, ESMA welcomes that IAASB engaged to analyse possible additional guidance to supplement current guidance in ISA 570 *Going Concern* in the area of clarifying '*material uncertainty*' with respect to going concern. ESMA would urge the IAASB to work together with the IASB in addressing auditing as well as accounting implications of going concern assessment, assessment of material uncertainty on the ability to continue as a going concern and the notion of "not having realistic alternative to continue as a going concern".

Question 10: What are your views on the value and impediments of the suggested auditor statement in relation to other information? (See paragraphs 65–71.)

32. While supporting including an auditor's statement in relation to other information, ESMA questions whether the suggested wording of the paragraph in the auditor's report does not lead to confusion and could in a way not widen the expectations gap. In particular, the last sentence of the suggested paragraph can be confusing.

33. Consequently, if the scope of the audit as currently defined in ISA *720 The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* is retained, a more detailed explanation of the responsibility of auditors related to other information could be included in the suggested auditor statement. In addition, when developing final standard, it might be useful to explain in more detail the notion of material inconsistency.

34. ESMA believes that there is a merit in trying to find out a common background that would enable to identify other information, despite the challenges of identifying it across various jurisdictions. High level principles for identification of other information can be used as a driver for existing jurisdiction specific guidance, where appropriate.

35. Even though beyond the current scope of the audit, ESMA would encourage the IAASB to further explore ways how to enhance auditors reporting on other information, e.g. by providing explicit assurance on selected other information.

Section: Clarification and Transparency

Question 11: Do you believe the enhanced descriptions of the responsibilities of management, TCWG, and the auditor in the illustrative auditor's report are helpful to users' understanding of the nature and scope of an audit? Why or why not? Do you have suggestions for other improvements to the description of the auditor's responsibilities? (See paragraphs 81–86.)

36. ESMA supports clear description of the responsibilities of the auditor and their distinction from those of the management. In the same time, ESMA is concerned that the description of the responsibilities of auditor is boilerplate and that it is not adapted to include entity specific information. In order to be useful, the description should be entity specific and provide additional information to the users. In particular, more specific explanation of the responsibilities related to the assessment of going concern assumption would help users to understand the audited financial statements.

Question 12: What are your views on the value and impediments of disclosing the name of the engagement partner? (See paragraphs 72–73.)

37. ESMA would be in favour of disclosing the name of the engagement partner but also understands, from a global perspective, that this issue may be finally addressed by local legal requirements in line with legal backgrounds of different jurisdictions. In the European Union, this issue is already addressed by article 28 of the Audit Directive 43/2006.

Question 13: What are your views on the value and impediments of the suggested disclosure regarding the involvement of other auditors? Do you believe that such a disclosure should be included in all relevant circumstances, or left to the auditor's judgment as part of Auditor Commentary? (See paragraphs 77–80.)

38. Disclosure of involvement of other auditors has a significant value to the users as it allows them to assess the scope of involvement of other auditors from the scope of the work the group auditor has performed. Providing this type of information in the auditor's report enhances the transparency on the audit of a group and its components, without necessarily impeding the sole responsibility of the group auditor. To this effect, this section should include an explicit statement that the group auditor remains solely responsible for the audit opinion. Consequently, ESMA believes that disclosure regarding the involvement of other auditors, should be included in all relevant circumstances.

Question 14: What are your views on explicitly allowing the standardized material describing the auditor's responsibilities to be relocated to a website of the appropriate authority, or to an appendix to the auditor's report? (See paragraphs 83–84.)

39. To be useful, auditor report shall include only information that is entity specific and provide additional information to users. Consequently, material describing the auditor's responsibility that is entity specific shall be included in the main part of the auditor report (e.g. section on auditor commentary or on going concern).

40. We believe that other information could be located in an appendix to the audit report.

Section: Form and structure

Question 15: What are your views on whether the IAASB's suggested structure of the illustrative report, including placement of the auditor's opinion and the Auditor Commentary section towards the beginning of the report, gives appropriate emphasis to matters of most importance to users? (See paragraphs 17–20.)

Question 16: What are your views regarding the need for global consistency in auditors' reports when ISAs, or national auditing standards that incorporate or are otherwise based on ISAs, are used? (See paragraphs 21–23 and 87–90.)

Question 17: What are your views as to whether the IAASB should mandate the ordering of items in a manner similar to that shown in the illustrative report, unless law or regulation require otherwise? Would this provide sufficient flexibility to accommodate national reporting requirements or practices? (See paragraph 17 and Appendix 4.)

41. ESMA agrees with the suggested structure of the illustrative report as this structure gives more appropriate prominence to matters of most importance to users. In particular the prominence given to the Auditor's Opinion and Basis for Opinion will help users to prioritise information in a more extensive auditor's report. For the sake of global consistency, this structure should be mandated, to the extent possible, unless local law or regulation requires otherwise.

42. At the same time, in order to ensure global consistency of auditor's reporting, ESMA would encourage the IAASB to closely monitor the current work being done by the Public Company Accounting Oversight Board (PCAOB) and the European Commission regarding the content of the auditor's report.

Question 18: In your view, are the IAASB's suggested improvements appropriate for entities of all sizes and in both the public and private sectors? What considerations specific to audits of small- and medium-sized entities (SMEs) and public sector entities should the IAASB further take into account in approaching its standard-setting proposals? (See paragraphs 91–95.)

43. ESMA believes that the proposed changes are best suited to public interest entities. However, the principle of proportionality should enable proper implementation of the proposals for all entities based on the needs of the users and based on the size and complexity of the operations of the audited entity. Given that ESMA's focus is on listed entities, we are not commenting about the appropriateness and proportionality of the proposals to audit of SMEs.