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Submitted by e-mail

Subject: Exposure Draft IAASB Reporting on Audited Financial Statements

Ref: B2013.53  
The Hague, 22 November 2013

Dear Mr. Gunn,

We welcome the opportunity to respond to the International Auditing and Assurance Standards Board (IAASB) Exposure Draft 'Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)'. By way of background, and to put our comments in context, Eumedion is the Dutch based corporate governance forum for institutional investors with interests in Dutch listed companies. Our 69 Dutch and non-Dutch participants - with a long term investment horizon - have together more than € 1 trillion assets under management.

We very much appreciate the direction the IAASB is exploring in reaction to the many calls from investors and broader society to obtain more information from the statutory auditor.

Notwithstanding the responsibility of the management and the board of directors (hereafter: the Board) for the quality and completeness of the Annual Report and Accounts (hereafter: annual financial report) and other disclosed (non-)financial information, we believe that the auditor's report could become much more relevant and useful for investors. For the purpose of investors' investment decision making, more information about the audit performed and the communications

between the auditor and those charges with governance (audit committee) should be disclosed. Accordingly, users will be better able to understand and weigh the conclusions of the audit as reflected in the audit opinion.

### **General remarks**

Institutional investors heavily rely on the availability of relevant, reliable and understandable information, which is the responsibility of the Board and its Audit Committee. The disclosed information, like the annual financial report should reflect the company's considered view of the information investors need. The integrity and the quality of the annual financial report are supported and strengthened by a robust external, independent audit, carried out objectively and undertaken with professional scepticism on the part of the statutory auditor. The audit process, including the communication of relevant information to shareholders, should become an insightful component of the overall financial reporting framework.

Although the "pass/fail" nature of the opinion is generally highly valued by investors, the auditor's report as a whole contains little underlying detail and should provide more entity-specific information. The latter is evidenced by the limited use of 'emphasis of the matter' and 'other matters' paragraphs and the absence of references to other core elements of the audit, such as the assessment of significant risks to material misstatements and the underlying judgments and assumptions of the Board. Institutional investors, investing in listed companies, are most exposed and affected by the current lack of information. Indeed, change is essential.<sup>1</sup>

In light of our long held concerns, we believe that the proposals set out in the Exposure Draft contain significant and useful improvements to audit reporting. Whilst the primary focus should be on the Audit Committee's report to include the substance of the matters the auditor has communicated to the Audit Committee, as it is the Board's responsibility to report to shareholders in the first instance, auditors have a crucial role attesting the veracity of this information and demonstrating the appropriateness of the audit conducted. Therefore, it is appropriate to provide increased information within the auditor's report to shareholders.

We are confident that the proposed enhanced audit disclosures will help institutional shareholders in their dialogues with investee companies to discuss the appropriateness of financial information when fulfilling their responsibilities to act as engaged shareholders. However, we are concerned about the timelines for finalising the proposed ISA's. As set out in the Exposure Draft it will take at least another four years (until 2017) before the enhanced auditor's reports would be available to

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<sup>1</sup> Paragraph 6 of the exposure draft.

users. Given the profound flaws in the current audit reporting model, we would urge the IAASB to significantly speed up the reform process.

Below you will find our answers to some questions raised in the Exposure Draft.

**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. Eumedion believes that the proposed introduction of a section in the auditor's report describing the matters of most significant in the audit ('key audit matters') could enhance the relevance and value of the auditor's report to users, while not resulting in unreasonable costs.

However, we continue to believe that the IAASB can go further, and require that the new section also includes:

- an entity-specific explanation of the auditor's approach towards materiality;
- the entity-specific scope of the audit.

As mentioned in paragraph 79, the 'approach towards materiality' and 'the scope of audit' are not expected to meet the proposed definition of 'key audit matters'. As a result, only in the rare case of an auditor coming up with an other matters paragraph, the two important audit issues can become available to users.<sup>2</sup> It would be better to include the two issues in the new key audit matters section. Accordingly, the new ISA 701 would be more in the spirit of the revised ISA in the UK and Ireland, which audit reporting standards we believe are currently best practice, at least from an institutional investor perspective.

**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?

Yes, we endorse the IAASB's approach that the entity-specific matters to be communicated in the auditor's report should have a matter of professional judgement. We also support that the auditor in making this determination should cover areas that generally require significant attention of auditors, including:

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<sup>2</sup> Page 30 of the Exposure Draft.

- areas of significant risks of material misstatement or involving significant auditor judgement;
- areas in which the auditor encountered significant difficulty during the audit;
- circumstances that required significant modification of the auditor's planned approach to the audit, including the identification of a significant deficiency in internal control (paragraph 8).

The material set out in ISA 701 could contribute to sufficiently consistent auditor judgments in determining key audit matters.

**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?

Eumedion believes that the proposed paragraphs A30-A43 will significantly assist auditors in determining the nature and extent of the description of an individual key audit matter. In particular, the proposals made on describing the effect of a significant matter on the audit (paragraph. A38-A41) may help users to understand why matters were key audit matters. These should explicitly not be limited to matters that relate to individual line items in the financial statements; it could relate to any key matter where the external auditor sees room for improvement, internal controls, internal organisation, legal issues, or the use of a more robust valuation model. Also making a reference to where the matter is disclosed in the financial statements enables users to understand both management's and other perspectives (A42-A43).

**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.

Eumedion generally believes that the five illustrative examples on page 13-14 make clear that the concept of key audit matters may have additional informational value for institutional investors and other users. The examples' topics, content and tone show that the concept offers flexibility and could be tailored to the entity's features and circumstances based on the auditors' judgement of what is most significant.

The two most useful examples for Eumedion are 'Revenue Recognition Relating to Long-Term Contracts' and 'Valuation of Financial Instruments'. The least interesting, almost boiler plate, example is the description of the 'acquisition of XYZ business'.

Broadly, Eumedion believes that elements that would provide valuable insight for investors are:

- 1) off-balance sheet obligations, including operating lease obligations and take-or-pay contracts;
- 2) a brief description of the risks/potential impact if the raised concerns by the auditor are not properly addressed;
- 3) a brief description of the interactions that the auditor had with the company after it raised this matter as a potential key audit matter (for example: the company agreed to start a project that will significantly mitigate the concerns raised within X months; or the company does not agree with the auditor and dismisses the concerns based on arguments X and Y).

**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?

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

(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?

Eumedion supports the IAASB approach that it is likely that there are always one or more matters that are 'key' in the audit. Obviously, the statutory auditor should have the general possibility to comment on the most important aspects of his audit, such as significant risks, the concept of materiality and the scope of the audit.

We recognise that under limited and extraordinary circumstances there might be no key audit matters to communicate (e.g a small listed company with very limited operations or assets). In such a case, it seems appropriate to require (1) auditors to discuss the conclusion that there are no key audit matters to communicate with the engagement quality control reviewer and (2) to explicitly disclose a statement that there are no key audit matters to report (paragraph 47 and 48). We do not agree that a such a statement would be confusing for institutional investors, as suggested on page 25 of the Exposure Draft. Rather, it could increase users' confidence in the auditor's assessment of the appropriateness whether any key audit matter should be communicated.

**Questions 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 would strongly prefer the scope of the audit to be disclosed in the key audit section rather than in the other matters paragraph, as proposed on page 30 of the Exposure Draft. It is important for institutional investors to receive proper information on the scope of the audit conducted. The result of limiting disclosure of planning and scoping of the audit to the other matters paragraph, which is hardly used by auditors in practice, will be that users are effectively kept in the dark about these important matters.

**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

Eumedion believes that these proposals would be helpful and informative to investors, as the statutory auditor will be required to provide explicit statements on the appropriateness of the entity's going concern assumption and any material uncertainties on the entity's ability to continue as a going concern. Going concern, and the assumptions associated therewith, are of critical importance to users. In light of this it is also important the IAASB provides additional clarification for what constitutes a "material uncertainty". For instance, would an economic downturn in a certain sector, that could seriously impact the preparer's financial condition, require auditor disclosure on the use of the going concern assumption?

Even more significant is probably the issue of how going concern is assessed and communicated by the Board. For the financial statements to give a true and fair view, companies should determine as to whether the going concern or the liquidation basis of accounting should be used. However, the threshold of distress at which a liquidation basis must be adopted is very high in the

IFRS and other relevant accounting frameworks. As a result, the going concern assumption provides only little information to stakeholders about the economic and financial viability of the company and to help demonstrate the Board's governance of the company in that respect.

Accordingly, we believe that the Board should include a concise and understandable going concern paragraph in the annual financial report in which all significant issues are described that supports the Board's assessment of whether the company is a going concern. This information should always be provided, not just when there are material uncertainties about the going concern status of the entity. The UK Lord Sharman Report of June 2012 delivers some very thoughtful recommendations in this regard.<sup>3</sup>

We strongly endorse the IAASB's holistic approach to engage in discussions with other (inter)national accounting and audit standard setters (e.g. IASB, FASB and the FRC), about what should constitute a going concern, the thresholds and what establishes a material uncertainty.

**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?

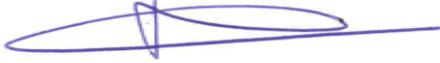
Eumedion would strongly oppose the introduction of another disclaimer used by auditors. Institutional investors and other users are perfectly aware of the fact that a going concern assumption cannot eliminate the risk that economic or financial distress will arise or the possibility of failure. A mandatory disclaimer as proposed by the IAASB will only result in the two positive statements set out under question 9 becoming less useful for users.

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<sup>3</sup> The Sharman Inquiry, 'Going Concern and Liquidity Risks: lessons for companies and auditors', June 2012 (<http://www.frc.org.uk/Our-Work/Publications/FRC-Board/Sharman-Inquiry-Final-Report.aspx>).

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact person is Wouter Kuijpers ([wouter.kuijpers@eumedion.nl](mailto:wouter.kuijpers@eumedion.nl); tel. + 31 70 2040302).

Yours sincerely,

A handwritten signature in blue ink, consisting of a series of loops and a long horizontal stroke extending to the right.

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