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Dear Madam or Sir

Enhancing the Value of Auditor Reporting: Exploring Options for Change

The European Banking Authority (EBA) welcomes the opportunity to comment on the Consultation Paper on enhancing the value of auditor reporting.

The EBA has a strong interest in promoting sound audit practices supporting high quality corporate reporting which is a crucial element of market confidence and market discipline. Useful and understandable reporting from auditors should be an output of high quality audits and therefore we welcome this discussion.

The comments in the Appendix are based on our perspective as a prudential banking regulator. This role comes with a degree of priviledged information access not available to many market participants, giving us a somewhat unique perspective from which to examine areas for expanded auditor reporting.

Our comments, while not structured according to the questions in the Consultation Paper, address the matters of key relevance to us as follows:

- Principles upon which to base change
- The degree and nature of change needed and worth exploring
- Benefits and limitations of certain changes
- International harmonisation

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If you have any questions regarding our comments, please feel free to contact Ms. Patricia Sucher (+44 20 7066 5644) in her capacity as Chair of the technical group that coordinated the response.

Yours sincerely

Andrea Enria

EBA Chairperson

Appendix

Section II of the Consultation Paper (CP) provides a fair and thoughtful description of the issues surrounding audit reporting in today's environment. The notion of expectation gaps and information gaps captures the issue well and needs to be addressed. We therefore welcome the opportunity to explore the potential for auditors' (and possibly audit committees') reporting to fill these gaps.

Principles to retain

In order to address the existing shortcomings of audit reports, enhancements will inevitably involve an increase in information provided by the auditor beyond that in the existing report which provides the 'binary' outcome of the audit: unqualified or qualified.

However, any changes should be considered within the constraints of the following important principles:

Division of responsibility

There are two sources of information gaps: i) shortcomings in information provided by management by way of disclosure, and ii) insufficient information provided by the auditor *about their audit*. Auditors' reporting on financial statement audits can only fill the latter gap as it must remain the responsibility of management (and ultimately the board of directors) to provide disclosures that are adequate to present a true and fair view of the company's affairs (driven by the adequacy and application of accounting and disclosure requirements). Based on this fundamental concept, we agree with the concern raised in the CP about 'duelling information' and the risk posed if the auditor originates information about the entity rather than management.

Clear opinion

Additional information from the auditor on financial statement audits would be useful such as the auditor's commentary on areas of significant audit risk, judgments on key audit and accounting issues, areas of significant debate with management and the audit committee, 'close calls' and alternative accounting treatments, and the nature of audit evidence obtained. However, this supplementary information should *complement* the ultimate opinion which must remain an unequivocal (i.e. still 'binary') conclusion on the truth and fairness of the company's financial statements.

Any dilution or detraction from this decisive opinion would risk misinterpretation and diminish the value of the independent opinion in lending credibility to financial statements. By the same token, we believe that increased use of 'emphasis of matter' paragraphs in opinions may be counter-productive to the extent that they detract from the decisiveness of the auditor's opinion. If the use of 'emphasis of matter' paragraphs were to be increased, this should be done in such a way that they do not undermine the binary outcome of the audit. They should be focused at improving users' understanding of matters which are truly fundamental to the financial statements without giving any qualifications to the opinion.

Degree and nature of change

Changes to existing audit reports

We believe that this discussion must go beyond a reconstruction of the existing audit report in order to adequately address the information and expectation gaps that exist. These changes are explored in more detail in the section that follows ('Benefits (and limitations) of change'). That said, certain improvements suggested in section III, A of the CP would be helpful, including the following:

- Increasing the prominence of the opinion section of the report; for instance by positioning it at the begining of the report;
- Further explaining the respective responsibilities of auditors and management;
- Clarifying or reducing 'technical language';
- Cross referring to a full explanation of the scope of the audit (e.g. to elsewhere in the annual report, an appendix to the audit report, or an external source); and
- Clarifying the auditor's responsibilities in respect of information in the annual report other than the financial statements and requiring the use of an affirmative statement when there is no material inconsistency between these and the financial statement.

These enhancements would provide the reader with relevant additional information about the audit, thereby narrowing the expectation gap, but should be made in a concise manner avoiding an unduly enlarged audit report.

Broader changes to auditors' reporting

The CP also discusses a more fundamental reform of audit reporting including (i) the provision of assurance on information not within the current scope of the financial statement audit, and (ii) an enhanced corporate governance model.

We think it is worthwhile exploring other areas where assurance from auditors would be beneficial; bearing in mind that some areas of subject matter lend themselves to the provision of assurance more than others (for example we have doubts as to whether auditors would be able to provide assurance on forward looking information, and defining the scope of such engagements would also present challenges).

As we favour improving auditor reporting *within the existing scope of financial statement audit*, assurance on additional areas should be covered in separate reports, while the audit report remains focused on the financial statements. However, it might be beneficial if areas where additional assurance was provided are named in the audit report.

Our comments that follow focus on improving auditors' reporting on financial statement audits, providing more information on the audit work carried out, the areas of judgment, and the auditor's assessment thereof (i.e. achieving a similar objective to the French model of 'justification of asssessments').

Benefits (and limitations) of change

Narrowing the gaps

As suggested above, we see the merit in exploring models which expand auditors reporting, thereby enhancing users' understanding of the scope and findings of their work. This would serve to narrow both the information gap and the expectation gap. On the latter, it would be beneficial for enhanced information to be provided on the auditor's work on important areas such as fraud risk and the use of the going concern assumption – two often misunderstood areas of an auditor's remit.

Impact on quality of financial reporting

One positive consequence of expanding auditors' reporting will be the potential impact on the quality of financial reporting caused by the transparency of the auditor's report and the process necessary to produce such a report. This required transparency will create a healthy level of tension between management and auditors which may result in better financial reporting. For instance, a requirement for auditors to be transparent about their consideration of key judgmental areas, including management disclosure about these areas, may lead to more robust analysis and improvements in disclosures by management in order to avoid an audit report which is at odds with or appears to criticise management's reporting.

This will have the significant benefit of highlighting those judgmental areas of an audit which the auditor does not necessarily disagree with or are not sufficiently significant to warrant a qualification (or emphasis of matter), but are still material areas of interest to users. In other words it may become easier for auditors to report such matters without undermining, compromising or indeed modifying the ultimate opinion.

Auditors' interaction with audit committees

The concept of an expanded audit committee report upon which the auditor opines is worth exploring as it will create a forum for auditors and the body that oversees the audit to agree upon and communicate to users the key areas of judgment in the financial statements. A required report could therefore facilitate better communication and resolution of these matters. This benefit needs to be balanced against the extra time it may take to develop and provide a coherent and reconciled report of auditor and audit committee views given already challenging public reporting timeframes.

Limitations

The above benefits come with challenges that must be addressed including:

- Risk managing and/or relationship managing behaviours may create a natural tendency to 'water down' or overly standardise the expanded auditor's report, making it less useful;
- The criteria / threshold for inclusion of matters in the expanded auditor's report will require judgment and may differ from audit to audit

and firm to firm, hindering comparability. This would need to be addressed by clear and adequate guidance in whatever revised auditing standard is introduced;

- Companies may have concerns about the disclosure of sensitive or proprietary information. The principle of confidentiality shall be respected, thus the report shall not provide the information which is restricted to managers of the company or competent authorities;
- Auditors will likely have concerns about their risk of liability; and
- This may pose a threat to auditors' relationships with management, thereby hindering audit quality. This may materialise through less than transparent dialogue (in fear of critical comments in the expanded auditor's report), or damage to the relationship caused by heightened debate on sensitive or contentious issues. The auditor's relationship with management is fundamental to audit quality to the extent that there must be trust, openness, and a willingness to challenge with an independent mindset.

International harmonisation

Noting the similar document published recently by the PCAOB on this topic, and the fact that there is currently disparity in auditor reporting regimes across different territories globally, we encourage the IAASB to work with its global counterparts, notably the PCAOB, as this area is further developed.