

# Briefing Paper

*Standing for trust and integrity*

June 2011



## Developing the Role of the Auditor and Auditor's Communication

*This Paper aims at proactively contributing to developing the future role of the auditor as well as auditor's communication. FEE is open for changes in these areas and is looking forward to a fruitful dialogue with all stakeholders on these matters.*

*As far as developing the role of the auditor is concerned, it could be extended to include explicitly assurance on business risks and on forward looking information in addition to the current focus on past performance.*

*Auditor's communication could benefit from a better alignment of public expectations of audit with audit performance which would involve a clearer articulation of the auditor's societal role. Within the audited entity, more regular communication with the auditor could also greatly improve the capacity of its governing bodies to fulfil their oversight role.*

### Dynamic path of change

The European Commission launched a debate on the suitability and adequacy of the statutory audit, one aspect of this debate being the development and communication of the role of the auditor. FEE agrees that it is worthwhile to contribute to this debate and to consider the lessons which can be learned from the recent financial crisis as it resulted in some banks revealing significant losses in their annual financial statements, most of which had clean audit reports over the last reporting period.

FEE, like the European Commission, firmly believes that the audit and the auditor continue to have an essential role to play in today's changing economy, supporting stable capital markets and financial systems, as well as the development of SMEs. FEE therefore agrees with the European Commission and European Parliament that the status quo is not an option, as well as with its objectives of reassessing and enhancing the value of the audit. However, since the audit is an integral part of the financial system operating in today's rapidly changing world, it is essential to consider the role of the auditor in the financial reporting system in a dynamic way rather than in isolation.

### Developing the future role of audit and the auditor?

Audit is at a crossroads and choices are being made which may take the profession down a road which will be more focused on compliance or one which provides more valuable business assurance to market participants.

FEE is engaged in dialogue with policymakers and other stakeholders to do further work on the future role of audit and the auditor. To better

align audit performance with public expectations it is essential that business and policy makers are closely involved in how the audit process can evolve to meet the changing (market) expectations of investors and others such as policy makers. However, any changes implemented should be carefully analysed and researched to assess their likely impact and any unintended consequences. Auditors can do more, but their role needs to be balanced with respect to the liability that it brings.

Any change to the responsibility for the financial statements and reporting (which logically lies with the directors and not the auditors) or to the financial information that should be made publicly available would need to be carefully assessed. A comprehensive evaluation of the whole financial reporting system is needed and supported by FEE. For instance, FEE is already engaged in considering the reform of the 4th and 7th Directives and the potential benefits of 'integrated reporting', bringing financial, governance, environmental and social reporting as well as management reporting into a consistent framework which could result in significant changes.

### The need for high quality audits

The magnitude and scale of the financial crisis has led some to question the quality of the audits performed during the period and suggest a more sceptical 'back to basics' approach, involving a greater focus on obtaining evidence to support the commercial substance of the assets and liabilities reported at the year-end.

Some regulators criticised auditors for a lack of professional scepticism by being too ready to accept the views of their clients on for instance accounting assumptions and estimations. Auditors should respond to

this criticism and work towards demonstrating the degree of scepticism exercised in the documentation within their audit files but, more importantly, work towards reinforcing the importance of the message to their partners and staff in the training they receive and in the execution of the work they undertake.

These perceptions are important, but auditing is a complex matter and

has developed over many years showing that a risk-based approach, obtaining assurance from many sources is the best approach. The International Auditing Standards (ISAs) are founded on such a risk-based approach and have been clarified and reviewed during and since the crisis. FEE believes that adoption of these standards would respond to the key concerns expressed by the European Commission as well as enhance consistent audit quality, especially for the audits of groups.

## Strengthening the role of the auditor together with the role of those charged with governance of entities

### The audit is an integral part of a company's corporate governance system

The depth of knowledge pertaining to each individual audit client that an auditor obtains during the course of an audit places the auditor in an optimal position to provide support to those charged with governance or those within a company responsible for overseeing management (e.g. the audit committee, the supervisory board or non-executive directors in public interest entities or the owner in a small entity). By keeping them informed of significant matters and communicating with them on a regular basis, the auditor can greatly improve their capacity to fulfil their oversight role.

### Communication between the auditor and the audit committee

For public interest entities, the auditor is already required by the Statutory Audit Directive to report to the audit committee (or equivalent supervisory board or non-executive directors) on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process. As the Statutory Audit Directive was only transposed in a number of European Union (EU) Member States last year, it is too early for the benefits of these reforms to have fully materialised throughout the EU since such legislative and regulatory changes do not immediately induce behavioural change and impact market structures.

Key ISAs<sup>1</sup> implement this provision for the audits of all entities and further require the auditor to seek an effective two-way communication and dialogue, so that key information relevant to the audit is shared between both parties.

FEE firmly believes that this is a key aspect of the audit which can be enhanced in practice in order for the audit to provide real and effective support to those charged with governance within a company, and also to enable the auditor to gain information relevant to the audit to which there might otherwise be limited or no access, thus enhancing audit quality.

### The role of the auditor and more extensive private audit reporting

In most European Union Member States, beyond the requirements of the Statutory Audit Directive, the auditors of public interest entities already report more detailed information to those charged with governance. In addition to detailed information on particular issues encountered during the audit, like material weaknesses in the internal controls, significant estimation uncertainties, etc., this may well include information to which the auditor becomes privy which should not be made publically available. Publicising certain sensitive information could have unintended consequences and potentially harm the entity and its stakeholders.

Therefore, it would be more beneficial to enhance private communication and dialogue between the statutory auditors, the board and/or audit committee and any internal audit function or external supervisors (especially in regulated financial services). For example, in some EU Member States like in Austria, Germany and some Nordic countries, the provision of additional information to those charged with governance is governed by regulation and is included in a special long form report, which can also be submitted to supervisory authorities.

In regulated industries, more open and regular dialogue between external auditors, supervisors and entities could also be improved. The exchange of information should be done as a three-way communication between the entity, the relevant regulator and the auditor. The information exchanged should relate to the area of supervisory responsibility of the regulator in question. A proper balance will need to be struck by avoiding the creation of an information overload that would reduce the accessibility to and relevance of key information as well as the production of self-fulfilling prophecies that would have counterproductive effects threatening entities' existence.

### The role of the auditor and more extensive public audit reporting

A better alignment of public perceptions and expectations of audit and audit performance will involve a clearer articulation of the auditor's societal role. In our market economy, an important role of the audit profession is to bring transparency and comfort as to the reliability of

<sup>1</sup> ISAs 260 and 265

corporate reporting. As reporting develops, so should auditing and auditors should embrace the opportunities to fulfil their role in areas such as governance, sustainability reporting, corporate governance statements, etc. which bring together financial and non-financial reporting.

If investors would like more reporting, auditors could also communicate more from their audit of the financial statements, without affecting the clear, binary 'pass/fail' nature of the current audit report opinion. Examples include:

- Public justification of the audit opinion like in France;
- A discussion of matters arising from the audit might be included in the audit committee report in the company's annual report.

The effect of more reporting will need careful consideration though, as it must not obscure the most important messages from the accounts or act as a self-fulfilling prophecy to adversely affect the existence of the business and the interests of its stakeholders.

## Future Expansion of the Role of the Auditor

### Reassessing and enhancing the role of the auditor

The recent crisis has called many aspects of the financial system into question worldwide. Undoubtedly, now is the right time to consider whether there is scope for enhancing the role of the audit and auditor so that their benefits are maximised within the world economy.

FEE therefore supports the initiative the European Commission has taken in starting such a debate and we look forward to continue developing solutions with the European Union. Auditors could be more effective and stringent in fulfilling their gatekeeper's role and could give broader assurance as well as a more informative audit opinion on the information required to be provided by the company. It will, however, be important to ensure that expectations as to what auditors should do are kept at realistic levels so that it will actually be possible for auditors to deliver on them within a fair regime of auditor's liability. In addition, as the audit is an integral part of the financial system, it will be necessary to consider the auditor's role in this context rather than in isolation.

### The role of the auditor and reporting on assumptions for going concern (short term) and information on key business risks (longer term) by management

Past performance is the focus of the financial reporting system, and it needs to be understood that the potential for historical financial statements to be used to predict or guarantee future performance is limited. In evaluating past performance, assumptions are made by the directors that the assets and liabilities reported will continue to be used in the business for at least another year. Auditors evaluate the directors' assumptions and only reports to shareholders if they disagree with them or believe that there are important matters to draw to shareholders attention that are relevant in considering whether the business is likely to remain a 'going concern'.

Additionally, the role of the auditor at the annual general meeting of public interest entities and large privately held entities could be reconsidered.

### The role of the audit and its timeliness

The audit reporting cycle, which normally only occurs once a year, might, given the fast pace of information exchange seen today, reduce the value of the auditors involvement in company's financial information. Public interest entities could have their half-yearly or quarterly information reviewed by auditors to increase the value and frequency of communications between auditors and investors. Developments in reporting technology, such as the extensible business reporting language (XBRL), which seeks to provide a common classification for reported information, may also help to give stakeholders more up-to-date information on businesses. The audit profession could consider developing ways to fulfil their societal role and bring transparency and reliability in these new reporting mediums.

Boards could include in their annual report details on their going concern assumptions and details on the key business risks that impact the business in the longer term. The auditor could report on these reports, and FEE would be pleased to be involved in the discussion surrounding the development of detailed requirements and procedures, a so called framework, for this reporting. Any debate as to the provision of information about a company needs to bear in mind that it is management and not the auditor who is primarily responsible for providing reliable and accurate information about the company.

### The role of the auditor and assurance on other forward looking information

At present, audits do not and are not aimed at explicitly providing comfort on companies' financial health.

It might be feasible to further extend the auditor's role to cover the statements made by a company's management - as included in the annual report - in relation to this type of forward looking information. Any decision as to whether this could be part of the statutory audit or part of a separate engagement would need further discussion taking due account of current national laws and regulations for financial reporting and auditing. For example, in some countries within the European Union the management report, the Corporate Social Responsibility (CSR) report, other environmental, social and governance (ESG) information and the description or effectiveness of the risk management system are currently subject to audit or another level of assurance, whereas in other countries they are not.

Therefore, further debate with all relevant stakeholders on proposals in this area would be needed to balance the information needs of the investor

