James Gunn, Technical Director
International Auditing and Assurance Standards Board
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Submitted by e-mail

Subject: Eumedion response to the IAASB Framework for Audit Quality

Ref: B13.20
The Hague, 14 May 2013

Dear Mr. Gunn,

We welcome the opportunity to submit comments on the International Auditing and Assurance Standards Board (IAASB) consultation paper 'A Framework for Audit Quality' (hereinafter: Framework). By way of background, and to put our comments in context, Eumedion is the Dutch based corporate governance and sustainability forum for institutional investors with interests in listed companies worldwide. Our 69 Dutch and non-Dutch participants - with a long term investment horizon - have together more than € 1 trillion assets under management.

General remarks

Eumedion supports the approach to develop a Framework that could help audit firms to perform high quality audits. Improving the vital role that statutory auditors have to play in the corporate governance structure of listed companies is what Eumedion has long been advocating. Likewise other institutional investors and representative organisations, we repeatedly expressed our concerns vis-à-vis the functioning of the audit market over the past five years.

The statutory auditor is initially a well-positioned expert to judge objectively a company's approach to risk and control. He has the statutory duty to report to shareholders and other users of annual accounts whether the company is presenting a true and fair view of the financial position. In order to facilitate optimal asset allocation, the investor's analysis is dependent on this audit opinion. However shareholders lack the information necessary to appraise directly the quality of any particular audit, and must rely on company management, the audit committee and the audit firm to ensure the quality of the audit. In particular in the case of institutional shareholders of listed companies, auditor's outputs available for those shareholders are very limited (*paragraph 147* of the Framework). Among institutional shareholders of listed companies there is an urgent need of greater transparency about the judgment made by the management and auditors in the course of preparing and auditing financial statements.

We believe that the extensive Framework proposed covers the most important aspects of audit quality, albeit capturing it in a single and globally recognised definition seems almost impossible to achieve. As many factors could contribute to audit quality, IAASB rightly considers that audit quality is likely to be achieved when the auditor's opinion on the financial statements can be relied upon as it was based on sufficient appropriate audit evidence obtained by an engagement team that:

- Exhibited appropriate values, ethics and attitudes;
- Was sufficiently knowledgeable and experienced and had sufficient time allocated to perform the audit work;
- Applied a rigorous audit process and quality control procedures;
- Provided valuable and timely reports; and
- Interacted appropriately with a variety of different stakeholders.

However, we have a number of comments on some of the issues raised in the consultation document.

QUESTIONS

Question 1
Does the Framework cover all of the areas of audit quality that you would expect? If not, what else should be included?

While the Framework comprises the most relevant areas of audit quality, we believe that more emphasis could be placed on the importance of specialised expertise. As listed companies and their businesses have been growing in complexity over the years, the work for a statutory auditor has become more and more demanding in terms of specialisation and expertise. Introducing a mandatory system of industry specialisation auditors, on top of the regular curriculum for auditors, could be an effective means of safeguarding that auditors continue to be able to perform high quality audits in relation to listed companies operating in economic environment of growing complexity.

In addition to that, we believe that in the Framework more attention could be paid to the revenue model some audit firms have today. There is a need to reassess the revenue model in order to ensure that auditors actually perform high quality work. To our understanding, in some local markets the today's partner salary level is still sometimes more dependent on commercial incentives (number of clients, turnover, cross selling, etc.) than on audit quality. In those structures auditors' contributions to turnover and profit are important factors for determining career opportunities and remuneration differentials within audit firms. The remuneration of partners of audit firms should be more aligned with the quality of the audit. The European Commission already addressed this issue in its proposal for a European Regulation in which it is stated that '*a statutory auditor or an audit firm shall have adequate remuneration policies providing sufficient performance incentives to secure audit quality*.'[1] We would very much welcome this approach to be embraced on a global scale.

Further, we would like to stress the importance of looking at the culture of audit firm staff recruitment. We have the impression that audit firms recruit primarily at universities. Once they join the audit firm, they become part of a corporate culture that is in many cases dominated by an 'up or out philosophy'. The core philosophy of this system is that an employee is only allowed to stay at a certain level for a certain time, after which it is 'up or out'. We believe that audit firms

[1] Article 6 (1) (k) of the European Commission's Proposal of 30 November 2011 for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities (COM(2011) 779 final).

could benefit from by hiring more staff with prior relevant experience outside audit firms (lateral entry access) and by stimulating that staff could opt for staying at a certain level for a longer period of time (specialisation).

Moreover, we have some concerns about *paragraph 7* in which the relation between audit quality and material misstatements is addressed. We acknowledge that an audit cannot be an *absolute assurance* that the financial statements do not contain material misstatements.[2] Nevertheless, an existing material misstatement that is not being detected by the statutory auditor should in any case be seen as a clear *indication* that the quality of the audit performed was not sufficient. We would recommend rephrasing paragraph 7 in order to emphasise the indicative value of an undetected material misstatement in terms of judging the quality of the audit performed.

Further, we concur with the considerably important principle that under all circumstances, a partner and his team should have sufficient time and resources to optimally perform the conduct of the audit (*paragraphs 81 and 82* of the Framework).

Question 2

Does the Framework reflect the appropriate balance in the responsibility for audit quality between the auditor (engagement team and firm), the entity (management and those charged with governance), and other stakeholders? If not, which areas of the Framework should be revised and how?

We partly agree. Obviously, the primary responsibility for performing quality audits rests with auditors themselves. They should exercise professional judgment when undertaking audits, applying a profound and appropriately skeptical approach to material issues, assumptions and evidence.

Likewise the governance and nature of the company audited are of paramount importance. Management should have the knowledge and be properly skilled and motivated to prepare and disclose accurate, relevant and reliable financial information. Management should allocate sufficient resources to the audit and neither be resistant to being challenged by the auditor nor being overly defensive when discussing contentious matters (*paragraph 184*).The audit committee has subsequently the responsibility to overseeing the financial reporting process and hold the management to account for fulfilling its responsibilities. The audit committees has also responsibilities for considering the audit process and recommending for approval the auditor

[2] ISA 200.

(re)appointment, and audit fees. We concur with the IAASB that audit committees and auditors should interact on an ongoing basis to fulfill the respective responsibilities and to positively affect audit quality (*paragraph 183*).

Institutional investors could contribute to audit quality by taking an active and engaged approach in holding management to account on matters on which the auditor has taken a position in his audit report (*paragraph 201*). However, in order to enable investors to seriously fulfill this engagement responsibility, both management and audit committees should be willing to constructively interact with institutional investors on financial reporting and audit issues. If management and the audit committee have a constructive and ongoing dialogue with engaged shareholders, they better know what those important users of financial statements and annual reports are interested in.

Improvements in audit reporting in general are also needed in order to enable shareholders to act as engaged owner on audit issues. While the future content and format of the auditor report is still under discussion, Eumedion welcomes many of the proposals made by the IAASB (Audit Commentary) and recently by the UK Financial Reporting Council (requiring the auditor's report to address risks of material misstatement, materiality and a summary of the audit scope) on this issue.

We also believe that a statutory auditor of a listed company has to attend the general meeting of shareholders in order to answer possible questions in relation to the auditor's report and the audit process. In some local markets, including in the Netherlands, this is already required in corporate governance codes, and has proven to offer an important platform for investors to start a dialogue with the auditor and management on the audit performed.

Question 3 How do you intend to use the Framework? Are there changes that need to be made to the form or content of the Framework to maximize its value to you?

We have no specific comments regarding this question.

Question 4 What are your views on the suggested Areas to Explore? Which, if any, should be given priority and by whom? Are there additional Areas to Explore?

We believe that priority should be given to put in place effective governance arrangements in audit firms so as to safeguard the public interest nature of the audit function and to promote the right ‘tone at the top’ (*area 1*). The governance arrangements should help to avoid that the firm’s commercial considerations result in actions and/or decisions that may have a negative effect on audit quality.

Another important area is the informational value of the audit report (*area 7*). Notwithstanding the responsibility of management and the board of directors for the quality and completeness of the 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. While the current binary nature of the audit opinion has great value to investors, more information could be given in the audit report on the audited company and the audit conducted itself. With such information users are better able to answer and weigh the conclusions of the audit as reflected in the audit opinion. The latter is also evidenced by the limited use of ‘emphasis of the matter’ and ‘other matter’ paragraphs and the absence of references to other core elements of the audit, such as the assessment of the risks in relation to the company’s continuity and the underlying judgments and assumptions of management.

Eumedion generally believes that both the IAASB and recently the UK Financial Reporting Council have made well-thought proposals for new styles of the auditor’s report to address investors’ information need. While the emphasis in the IAASB’s Audit Commentary concept is mainly on accounting judgments, the FRC approach focuses on including in the report the key judgments in the audit, including key risks, the materiality assessment, and a summary of the auditor’s scope.

Ideally, we would like to see a combination of the two. In the audit report we would both like to obtain more information of the statutory auditor on his work and the audit process (e.g. auditor’s assessment of risks and materiality), but should also have the opportunity to ‘alert’ shareholders on specific risks that are crucial for a true and fair view of the company’s health and its continuity, if the board fails to do so.

A new style of the auditor’s report, such as the proposed Audit Commentary, should be synchronised with the governance of the reporting chain more broadly. This means that when it comes to his findings on the key accounting judgments, the auditor should firstly communicate this to the audit committee as overseeing important accounting judgments is part of the audit committee’s work. The audit committee should subsequently decide on disclosing the findings on key accounting judgments in the annual report and then it is for the auditor to respond as to the completeness of these disclosures. Accordingly, the audit committee needs to be encouraged to provide more information on their work and the main issues they have addressed (*area 10*).

Finally, we would welcome listed companies to include in their annual reports an explicit statement that the business is in going concern together with supporting assumptions as necessary.

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; tel. + 31 70 2040 302).

Yours sincerely,

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