



**RESPONSE TO PCAOB RULEMAKING DOCKET MATTER No. 34**

**FINANCIAL REPORTING COUNCIL  
SEPTEMBER 2011**

## **1. Introduction and main points**

1.1 The Financial Reporting Council (FRC) welcomes the opportunity to respond to the PCAOB's Concept Release on potential changes to the auditor's reporting model. We are pleased to see the PCAOB consulting on this topic and we support the objectives that the PCAOB seeks to achieve through its proposals. Recent initiatives in the UK and Europe have also sought to address this and related issues. Whilst we believe that it is helpful where possible for there to be international consistency in substance if not always in form, alternative proposals to address similar issues will assist with an assessment of the relative effectiveness of different approaches.

1.2 The FRC is the United Kingdom's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC and its operating bodies have a number of responsibilities in relation to audit, including policy, standards, monitoring and investigations. These functions are carried out with the primary goal of improving audit quality.

1.3 Since the financial crisis the question has arisen as to whether the audit report is fit for purpose. Commentators have pointed to banks and other financial institutions which failed shortly after receiving clean audit reports. Whilst some of these comments are based on a misunderstanding of the purpose, scope and limitations of an audit, an attempt must be made to close the expectation gap if audit is to be considered fit for purpose.

1.4 In January 2011 the FRC published a discussion paper entitled Effective Company Stewardship – enhancing corporate reporting and audit. The aim of the paper was to consider how companies and auditors could better serve investors by providing more valuable and relevant information.

1.5 There are differences in UK and US approaches to corporate governance and reporting. For example, in respect of corporate governance matters the UK relies on a "comply or explain" approach rather than mandating disclosures. Nonetheless we believe that many of the principles in Effective Company Stewardship are applicable internationally.

1.6 In the event that different approaches are agreed in the UK, US and Europe consideration will need to be given to how best to deal with companies which are listed in more than one jurisdiction. We would suggest that, provided that the company's management provides the required information in the annual report, auditors are not obliged to duplicate it. This will ensure that companies with dual or multiple listings do not find themselves caught between different regulatory regimes.

1.7 Our submission concentrates on what we see to be the key issues and expands upon our preferred solutions.

## 2. Narrative reporting

2.1 The concept release identifies a number of issues with the audit report, including:

- The limitations of the pass/fail model.
- The prevalence of boilerplate language.
- Limited information about matters specific to the company.

2.2 The paper goes on to make a number of suggestions as to how the audit report could be improved and made more valuable to users.

2.3 The FRC agrees with the contention that the audit report does not always deliver the assurance that investors would like to see. However we believe that the audit report should not be seen in isolation from corporate reporting more generally. Some of the suggestions in the concept release, in particular the “AD&A” option, rely heavily on the auditor providing information some of which is in our view properly the responsibility of management. We appreciate that the PCAOB regulates auditors and not companies, and so an approach providing for the company to give further information may not be available to it.

2.4 It is a company’s directors and executive management who have responsibility for running that company and reporting on its performance. Management should, in the first instance, decide what information should be communicated to investors and the wider public. The auditor has a vital role to play in validating and challenging management’s views, and in assessing whether there are material inaccuracies or omissions.

2.5 The first step in improving the quality of information provided to investors and others should therefore be to make reporting by large companies more effective. Feedback received on our Effective Company Stewardship consultation indicates widespread dissatisfaction with current narrative reporting across all stakeholder groups. Investors in particular noted that annual reports have become longer and longer in recent years, without a corresponding increase in the relevance and value of the information disclosed.

2.6 The FRC is working with the UK Government to develop solutions to make improve narrative reporting. Likely solutions include:

- Introduction of a strategic report providing an overview of the business.
- Disclosure as part of that strategic report of an explanation of the links between company performance and the remuneration of directors and senior management.

- Greater transparency from directors about the activities of the company and disclosure of key operational risks.

### **3. Role of the audit committee**

3.1 An enhanced role for the audit committee is at the heart of the FRC's proposals. In recent years the audit committee has grown in strength and influence, and we believe that audit committees are well placed to deliver effective governance and oversight of the audit process.

3.2 Much of the work done by audit committees remains invisible to investors, with the result that a key opportunity to build confidence in financial statements is missed.

3.3 We propose that audit committees should report to the full board on the approach that they have taken to the discharge of their responsibilities, describing in such terms as they consider appropriate, and having regard to the commercial interests of the company concerned:

- The key sensitivities or risks, including the choice of accounting policies, that they identified to the integrity of the annual report, including the financial statements, and how they arranged for those to be addressed.
- Any matters of material significance identified by the audit committee that are not addressed elsewhere in the annual report and which, in the directors' view, should be known to users if the annual report, taken as a whole, is to be fair and balanced.
- The steps they took and the judgements they made to assess the effectiveness of the audit.
- The policies that they adopted to avoid the independence of the company's auditors being compromised through the provision of non-audit services.
- The process by which they reached their recommendation to appoint or reappoint (as the case may be) the company's external auditors and the reasons for that recommendation.
- Any dialogue that they may have had with investors in relation to any material audit issues (not addressed elsewhere in their report).

3.4 The full audit committee report should be published in the annual report.

### **4. Auditors and the audit report**

4.1 As noted above, it is the FRC's view that the primary responsibility for communicating key information on historical performance and future opportunities and risks lies with the company's directors and executive management. Substantive involvement by the auditor in direct reporting in this area runs the risk that the auditor takes on a management role.

4.2 For these reasons we do not believe that the auditor should be responsible for the provision of information on a company's business strategy or key risks. We do, however, believe there is scope for the auditor to add greater value in this area.

4.3 Firstly, we propose that auditors provide a fuller report to audit committees aimed at ensuring that the committee understands fully the factors that the auditors relied upon in exercising their professional judgement in the course of the audit and, in particular, in reaching their audit opinion. At a minimum, these are likely to include:

- The effectiveness of the company's system of control.
- The judgements made in the audit plan about what is material and the implications of those judgements for the level of assurance provided by the audit.
- The appropriateness of the accounting policies (viewed individually and in aggregate).
- Their overall conclusions on the valuations of the company's assets and liabilities provided by management (with particular reference to those that are significant to the financial statements).
- Any other matters identified in the audit plan or by the audit committee as material to the proper presentation of the company's financial position.

4.4 The audit report itself should then be expanded to provide:

- A new section on the completeness and reasonableness of the audit committee's report.
- Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

4.5 Our proposals most closely resemble Option C in the concept release. The FRC will shortly launch a consultation on changing UK auditing standards to reflect our proposals.

## 5. Conclusion

5.1 In conclusion, we believe that the audit report cannot be treated in isolation and that attempts to improve the usefulness of the auditor reporting model must begin with improvements to corporate reporting more generally.

5.2 The primary responsibility for providing information to investors should rest with the company's management. The auditor should review that information and supplement or correct it as necessary; the auditor should not be obliged to duplicate management disclosures. Our preference therefore is that the PCAOB to proceed with Option C.

5.3 For further information please contact Paul George, Director of Auditing, on +44 20 7492 2340 (email: [p.george@frc-pob.org.uk](mailto:p.george@frc-pob.org.uk)).