



Via Email

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Dear Mr Ball,

*Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with
International Standards on Auditing – ISA 200*

We are writing on behalf of the International Corporate Governance Network (ICGN). As you know, the ICGN is a global membership organisation of institutional and private investors, corporations and advisors from over 40 countries with capital under management in excess of U.S. \$10 trillion. The aim of the ICGN is to contribute to raising standards of corporate governance through the exchange of ideas and information across borders and the development of best practices. Information about the ICGN, its members and its activities is available on our website: www.icgn.org.

The purpose of the ICGN's Accounting and Auditing Practices Committee is to address and comment on accounting and auditing practices from an investors' and shareowners' perspective. The Committee through collective comment and engagement strives to ensure the quality and integrity of financial reporting around the world. For more information, please visit:
http://www.icgn.org/organisation/committee_membership.php?name=AAP

Thank you for the opportunity to comment on the redrafting of International Auditing Standards (ISA) 200 which contains the premise on which an audit is conducted as well the obligations of the auditor in conducting an audit of financial statements. ICGN members rely on auditors' work and their opinions in protecting companies themselves in the first instance¹, in making governance decisions as shareholders, and in making investment (equity) and credit (fixed income) resource allocation decisions. We are pleased that the International Accounting and Assurance Standards Board (IAASB) through the

¹ **Comment:** This addition is absolutely key. The law in the EU (and also most British derived law, ex the US) regards the audit as protecting the financial systems and integrity of the company itself, ahead of the public financial reporting. Second, the overarching objective is not only standardized/ "GAAP" consistent information (for buy-sell), but information that achieves accountability.

International Federation of Accountants (IFAC) have requested comments on the overall objective of the independent auditor and the conduct of an audit in accordance with the international standards on auditing (ISA). Defining the objective of the audit is clearly quite fundamental to any auditing standards framework, particularly if it will be considered sufficient to be used internationally.

In reviewing ISA 200 ICGN believes that there are significant problems with the way ISA 200 is defining audit objectives authoritatively. The objectives of ISA 200 are incomplete and may be potentially misleading. Also, ISA 200 uses explicit terms such as “material” and “reasonable assurance” that are not recognised in the laws in many places, but also seem to limit audit scope and possibly could be used as defenses in cases of negligence.

The ICGN is concerned that in some countries (and the whole of the European Union) the ISAs will go into law and would only confuse existing laws in the manner it is currently written. We note that two other IAASB-ISA, ISA 700 – Auditor Reports and ISA 580 – Management Representations, have already encountered legal problems and objections in their adoption by the Financial Reporting Council (FRC) -Auditing Practices Board (APB) - United Kingdom and Ireland, which covers four distinct legal jurisdictions², and which are by no means atypical globally in their basic legal requirements for audits under company law. ISA 700 was rejected in 2005, and ISA 580 was rejected in 2007.

We believe the problems with ISA 200 are linked with several issues of concern around ISAs generally:

- “materiality” being overly focused on size and then of what is presented, rather than what is significant according to more rounded business control tests;
- auditor responsibility in respect to fraud, in particular auditors missing control type frauds that may grow and have larger consequential effect. Financial reporting fraud (affecting third party users) is only a subset of frauds that harm businesses and shareholders;
- changing/limiting director (and hence joint and several auditor) responsibilities; and
- contractual limitation in engagement letters to the scope set out in ISA 200, further limiting the auditor’s accountability.

The ICGN is interested in the highest quality of auditing standards and standards of auditing practice globally. The fact that the United Kingdom and Ireland APB has already had to correct deficiencies in IAASB-ISA (or defer their adoption altogether), and that the EU may also have to go forward, is a matter of great concern. ICGN members are invested globally and therefore have an interest in the ISAs being of high quality in the first instance, as applied globally. ISAs may be applied in places with relatively weak or circumventable company law and where ISAs deficiencies are not corrected, or supplemented by sufficient local laws, may dilute the objective of the independent auditor. This may be particularly relevant with some tax-havens for instance in the context of large off-shore asset/cash rich subsidiaries.

Attachment I provides ICGN’s suggested improvements to ISA 200 and details where we believe deficiencies exist in the current wording of ISA 200.

Additionally, in reviewing ISA 200 as it relates to financial reporting, ICGN believes ISA 200 would be greatly strengthened if it aligned the overall objective of financial statement **auditing** to the objectives of financial statement **reporting and underlying governance and control frameworks**

² The Republic of Ireland, Scotland, England & Wales and Northern Ireland

required in Company Law systems. The primary purpose of the auditing profession is to opine on the financial statements themselves and also on the integrity of the financial control state of the business (wider in scope than merely “financial reporting”).

ICGN believes the overall objective of a financial statement audit is to express an opinion as to whether the financial statements meet the objectives of financial reporting and the governance and control standard to meet the needs of shareowners and what is required in Company Law. The objective of financial statement reporting is to provide information that is useful primarily to the shareowners and creditors, and secondarily to potential investors and creditors and others making similar resource allocation decisions. This information should be useful in assessing cash flow prospects, and it should provide information about an entity's resources, claims to those resources and changes in resources and claims. The objective of internal financial control is that financial management should operate effectively and efficiently safeguard assets and produce reliable financial information.

We would suggest the auditor's opinion include:

“In our opinion, these financial statements meet all of the objectives of financial reporting. Specifically, these financial statements provide information that is useful primarily to the shareowners and creditors, and secondarily to potential investors and creditors and others making similar resource allocation decisions. Additionally, in using reasonable skill and care in our review we provide that in our opinion, the financial statements and accounts give a true and fair view, that the company kept proper accounting records which are useful in assessing cash flow prospects, and they contain information about the entity's resources, claims to those resources and changes in resources and claims”

“In our opinion, Management's assertion that the systems of internal financial control are operating effectively and efficiently, that assets are safeguarded, and that financial information is reliable, as of [December 31, 2006], is fairly stated in all material respects based on the criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission (or similar schemes in other jurisdictions, i.e. Turnbull), and based on our testing of these controls.”

The ICGN would encourage the IAASB to consider these recommendations and the detail provided in Attachment I to provide a more robust standard in developing the objective of an independent auditor.

We appreciate the opportunity to comment. If you would like to discuss any of these points, please do not hesitate to contact Anne Simpson our Executive Director at +44 207 612 7098 or execdirector@icgn.org. Thank you for your attention and we look forward to your response on the points above.

Yours sincerely,



Christianna Wood
Chair, ICGN Accounting
and Auditing Practices Committee

cc: IAASB Members

Attachment I – ISA 200

True and Fair View Audits and Opinions – Paragraph 19 Sufficient Appropriate Audit Evidence

The typical full legal requirement in Company Law systems is for financial accounts to show a *true and fair view* (a director responsibility)³. Directors also have to have kept proper accounting records throughout the period (*to control the business properly throughout the period*). Auditors then form an *opinion* on both of these things using the *reasonable skill and care expected of a professional person*, in gathering evidence sufficient to form an opinion.

In typical company law the auditor opinion is on both presentation and the state of the underlying business financial recording and control as well. **The law typically does not prescribe materiality or reasonable skill and care, nor does the law limit the auditor duty of care to matters of presentation.**

Under the law, matters are binary. The auditor will be right or wrong in his opinion on the quality of the accounts and of the accounting, and either he will have used reasonable skill and care in reaching the opinion or he didn't.

The benefit of the statutory audit (company law) is that it is a check on management and directors; for fraud, negligence, bias, or error in performing their duties (both reporting and financial control). If errors are identified then it is up to the auditor through its management letter to identify the deficiencies not only to ensure that the financial accounts are “correct” at that time, but to also ensure that problems do not recur or grow.

The statutory audit gives a check on quality of the broad financial control of the company, as well as the accuracy of the public accounts (“financial reporting”). The statutory audit is aimed at protecting the company itself in first instance as well as giving appropriate transparency for the users of accounts.

Overall Objective of the Independent Auditor – Paragraphs 4-6

ICGN believes that ISA 200 falls short of the scope of the statutory company law type of audit as described above. As outlined in Paragraph 5 of ISA 200:

“In conducting the audit so as to achieve its objective, the overall objective of the independent auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to report on the financial statements in accordance with the auditor’s findings.”

“The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.”

These overall objectives don't necessarily provide the assurance that should be required in a statutory audit.

³ **Comment:** The legal responsibility in company law only lies with those who have accountability, precisely so that those who have accountability can't pass it down to management.

We believe there are 3 specific issues with the objectives set out in ISA 200. These include:

1) ***“The financial statements as a whole are free from material misstatement”***

This statement appears to be a redefinition (limitation) of full scope audit objectives, focusing on things that are already ***material*** (very large) in the context of the financial statements rather than a more rounded test of the significance to business and the actual state of its financial affairs through tests.

Some things, such as those involving large or high volumes of cash-asset movements, need to be audited in a context that is different than “materially not misstated” in the presentation in once-a-year published financial statements.

What is intolerable as an error in a control sense may be entirely different than what is tolerable as an error presentationally. \$1m stolen by a bank’s treasurer, is more of a risk to the business of the bank than using the wrong amortisation rate for something that is already a sunk cost such as goodwill, or depreciation.

“As a whole” is also a qualification. The test of reasonable skill and care attaches to individual items of significance to the business, and evidence about those items (including their control), not just the “financial statements” in their totality. ***“As a whole”*** appears to be directing materiality away from being inclusive of underlying issues of qualitative control relating to specific accounts items.

The term ***“financial statements”***, carries a different legal nuance to that which has been defined in law as “financial accounts”. This also seems to create scope for a clouding of the relevance of the accounts, accounting and control that sits beneath published financial accounts (“financial statements”).

2) An auditor ***“obtaining reasonable assurance”*** - is a different test to reasonable skill and care necessary to form an opinion, particularly in being applied against a different objective to fulfill scope audits (see 1 above).

An opinion is an opinion, it is either favourable or negative, “obtaining reasonable assurance” seems to be a vague standard of uncertainty, justifying a process of attrition rather than anything conclusive. Half an opinion is not an opinion.

“Reasonable assurance” also seems to be difficult to apply to different things generally. The auditor in law using reasonable skill and care needs to establish an opinion on the underlying integrity of control, *of many specific areas*, not merely gain “reasonable assurance” that what is presented in total is “about what is right”.

3) ***“The applicable financial reporting framework”*** – appears to be a limitation of scope of applicable law.

Auditors in company law regimes, do not just fulfill a financial reporting function, but function within a governance framework too.

Financial reporting and governance (detection and prevention of ongoing fraud or error) are interlinked, not separate as ISA 200 seems to imply. The auditor reports information to directors and management that he observes that may be harmful going forwards, whether or not they particularly affect the numbers as presented in the current accounts. The auditor also has the ability to resign and be heard at general meetings of the members.

The legal context

We cite the Barings Bank Singapore case, where the negligence was the auditors' oversight regarding the non-detection of a specific instance of fraud, and the consequences of that in the "governance" context (i.e. not preventing the fraud developing further). Barings exemplifies that the benefit to company of a company law based audit is not limited to the error in the financial statements for capital markets.⁴

We also cite Hong Kong (Auditing Standard 110)⁵ which makes it clear that the duty is to identify and report (to management/directors) financial control matters they have observed that may harm the business materially, not merely matters that are already manifestly material *in the* "financial statements".

More recent, we cite the case of where accounting firm BDO Seidman must pay \$170 million in compensation and provide punitive damages for its negligence in failing to reveal massive fraud in a financial services company backed by a Portuguese bank, Banco Espirito Santo.⁶

A clear articulation of the broader duty is also set out in the FRC's discussion of audit quality:

The most common definition of audit quality applied in academic research is:

"[the market assessed joint probability] that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach".⁷

Audit quality is not limited to the size of the problem in the financial statements.

The practical implications:

In practice auditors by following the objective of ISA 200 literally, may:

- fail to look at some things at all,
- when they do look, restrict their attention to that subset of poor accounting and control of financial reporting relevance only,
- unnecessarily try to separate issues when they do find problems, between business financial control and financial reporting control,
- and fail to take appropriate action when there is a problem in business financial control (as distinct from the more contrived definition of "control over financial reporting").

⁴ Para 749 – Barings Plc and Coopers and Lybrand and others and Barings Futures Singapore Pty Limited and others (2003) EWHC 1319 (Ch) – The High Court London 2003

⁵ Auditing Standard SAS 110 (Hong Kong). Para 59 (f)

⁶ August 15, 2007 Juror

⁷ DeAngelo (December 1981) Auditor size and Auditor Quality, Journal of Accounting and Economics, cited by the APB-FRC "Promoting Audit Quality".

www.frc.org.uk/images/uploaded/documents/Promoting%20Audit%20Quality%20paper%20web%20optimised.pdf

Shareowners are invested in companies, not purportedly accurate financial statements at a given point in time that is only backed up by limited scope audits.

Measured against the legal context, ISA 200, seems to allow for an audit in concept that is a limitation of scope and a limitation of the duty of care. The matter is not only one of an “expectations gap”, the issue is that ISA 200 may also be misleading.

We also note that ISA 200 overtly describes the inherent limitations (paragraph 12) of an audit. We question whether that should ever be a function of any auditing standard (particularly ones which may go into law).

Other issues around responsibility and liability:

We understand that auditors may in some jurisdictions, and under ISAs, also be able to use clauses in engagement letters that restrict the ability for breaches of the auditor duty of care to the company (for negligence or breach of trust) to be invoked by the company. Such clauses may be matched by similar clauses of the directors in the articles.

Such clauses allowing for the exclusion of negligence, breach of trust to the company of the directors and auditors leaves regulators in the position of focusing instead on the more sterile objective of market-accurate information. It does not escape the attention of the ICGN that the accounts of a company with depleted resources after a theft caused by breach of trust or negligence are technically accurate. The issue needs not to be a rather sterile form of accuracy, but the broader scope is a matter of integrity.

At a time that some accounting firms are overtly seeking to achieve liability limitation, we do not believe the standards framework is the right place to limit the scope of an audit in order to limit responsibility and liability.

Under the law as set out above auditors may be:

- i) correct in their opinion and they used reasonable skill and care
- ii) correct in their opinion, but they did not use reasonable skill and care
- iii) incorrect in their opinion, but they did use reasonable skill and care
- iv) incorrect in their opinion, and they did not use reasonable skill and care

Only in iv, is the auditor potentially exposed to a settlement for negligence, and the ICGN would assume that this is only a small fraction of total audits, as the company also has to have incurred significant loss (failed audits (as in ii) will not coincide with loss).

ISA 200, with the concept of “reasonable assurance” seems to create some doubt whether auditors would reach an opinion at all in any of the above 4 scenarios, i.e. in seeking to defend potential outcomes in iv), the conceptual basis of the audit for all companies is being lowered across the board.

We believe that the IAASB should include more robust audit objectives in ISA 200, so that sections can be taken out in jurisdictions where they are not applicable, and where shareowners have already agreed to these omissions. The deficiency in places that allows restriction is then visible, to both auditors in the field applying a standard, and to investors and other parties.

The audit objective of ISA 200 should state:

The objective of the auditor is to form an opinion (**three separate opinions**):

- on whether the accounts give a true and fair view, and
- whether the accounts comply with the relevant financial reporting and company law framework, and
- whether the company kept proper accounting records during the period, using reasonable skill and care in reaching the opinion,

and reporting breaches to the accounting systems, whether significant to the ongoing financial control of the company or the financial reporting of the company, to the directors, or the directors and shareholders as appropriate.