
STANDING ADVISORY GROUP MEETING

ACAP COMMITTEE'S RECOMMENDATION RELATING TO THE AUDITOR'S REPORTING MODEL

APRIL 7-8, 2010

Introduction

At the April 2010 meeting, the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Standing Advisory Group ("SAG") will discuss the following recommendation of the Advisory Committee on the Auditing Profession convened by the U.S. Department of the Treasury ("ACAP") relating to the auditor's reporting model:^{1/}

Chapter VII. Firm Structure and Finances

Recommendation 5: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model. Further, urge that the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards.^{2/}

In February 2005, the SAG discussed various issues regarding the auditor's reporting model, including changing the auditor's report to be more

^{1/} U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* ("ACAP Final Report") (October 6, 2008), available at: <http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf>.

^{2/} Ibid., pp. VII:13-19.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

descriptive.^{3/} At the October 2009 SAG meeting, some SAG members stated that it was important for the Board to consider improvements to the auditor's report in light of the ACAP recommendation.^{4/} Based on the feedback received from SAG members, and in light of the ACAP recommendation and other recent international developments, the PCAOB staff believes it is appropriate for the SAG to reconsider this topic.

At the April 2010 SAG meeting, panelists will present information relating to the history and evolution of the U.S. standard auditor's report and the ACAP recommendation. After the panelists' remarks, SAG members and observers will form break-out sessions to discuss potential ways to: (a) change the standard auditor's report and (b) clarify in the auditor's report the auditor's role in detecting fraud. On the second day of the meeting, PCAOB staff will present a summary of the break-out group discussions, and SAG members will have an opportunity to provide additional commentary.

This paper provides SAG members with background information regarding significant historical developments in the evolution of the U.S. standard auditor's report, background information on the ACAP recommendation, and recent developments in other countries relating to the auditor's reporting model. The paper also includes discussion questions relating to topics discussed in the breakout sessions.

Background

Significant Historical Developments in the Evolution of the U.S. Standard Auditor's Report

The current version of the standard auditor's report identifies the financial statements that were audited, describes the nature and scope of the audit, and presents the auditor's opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with U.S. generally accepted accounting principles ("GAAP").^{5/}

^{3/} See February 16, 2005 SAG briefing paper at: http://pcaobus.org/News/Events/Documents/02162005_SAGMeeting/Auditors%20Reporting%20Model.pdf.

^{4/} See October 14-15, 2009 SAG Webcast at: http://pcaobus.org/News/Webcasts/Pages/10142009_SAGMeeting.aspx.

^{5/} AU sec. 508, *Reports on Audited Financial Statements*. References to AU sections throughout this paper are to the PCAOB's interim standards

There has been a long-standing discussion and debate regarding the form and content of the auditor's report dating back to the early 1900's when there was an initial attempt to define accounting and auditing practice in the United States. The form and content of the auditor's report have also been studied and debated internationally. This section highlights key historical developments in the evolution of the standard auditor's report.

In the early 1900's, no authoritative accounting or auditing standards existed in the United States, and auditors wrote original (free-form) audit reports for every engagement.^{6/} According to an article published in the *Academy of Accounting and Financial Studies Journal* ("the Journal article"), one of the first U.S. companies to publish its financial statements accompanied by an auditor's report was United States Steel in 1903.^{7/} The United States Steel auditor's report presented the auditor's opinion and described the procedures performed by the auditor, which included, "[w]e have verified cash and securities by actual inspection," and "[f]ull provision has been made for bad and doubtful accounts receivable and for all ascertainable liabilities."^{8/}

In 1912, the American Institute of Accountants ("AIA", now known as the American Institute of Certified Public Accountants ("AICPA")), at the request of the Federal Trade Commission ("FTC"), issued "A Memorandum on Balance

adopted as in existence on April 16, 2003, except as superseded or amended by the PCAOB. These standards are on the PCAOB's website at: www.pcaobus.org. PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, also prescribes the content of an auditor's opinion on the effectiveness of the company's internal control over financial reporting for those companies that are subject to Section 404(b) of the Sarbanes-Oxley Act of 2002. The audit report may also reference that the financial statements were prepared in accordance with financial reporting frameworks other than GAAP, such as International Financial Reporting Standards ("IFRS").

^{6/} Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts To Influence the Auditing Standards Board*, 1 (Greenwich, CT:JAI Press Inc.), p. 38.

^{7/} D. L. King, and C. J. Case, "The Evolution of the United States Audit Report," *Academy of Accounting and Financial Studies Journal* 7, No. 1 (2003), p. 5.

^{8/} *Ibid.*, pp. 5-6.

Sheet Audits."^{9/} This memorandum was the earliest form of auditing guidance describing a suggested but not required form for the auditor's report.^{10/}

The Journal article stated that by the early 1920s, the auditor's report was reduced to one paragraph in length and was referred to as an audit of the "accounts and records" whereby the independent auditor would "certify" the "balance sheet" as being "correct."^{11/} The Journal article further stated that the FTC requested this shorter form of the auditor's report in order to promote "a more uniform system of accounting," because creditors and stockholders at the time "felt the need to have improved assurance as to the quality of the balance sheet figures."^{12/} According to the Journal article, audits performed at that time were referred to as "bookkeeping audits," which required the auditor to examine every transaction in order to verify financial information."^{13/}

In the early 1930's, the auditor's report was amended as a result of the *Ultramares* case.^{14/} Specifically, "the term 'certify' began to disappear from reports in an attempt to clarify that the report was an opinion and not a guarantee."^{15/} The auditor's report of 1934 was "the first report to have a *required* as opposed to a *suggested* report wording" and "was required for firms registered with the New York Stock Exchange."^{16/} According to a special committee of the AIA, the profession adopted a standard audit report because it would specifically accomplish two objectives: (1) institute uniform report language across firms, thus making reports more readily comparable and consequently reduce deficient

^{9/} Geiger, *The New Auditor's Report*, p. 12.

^{10/} Ibid.

^{11/} Vincent M. O'Reilly, et al., *Montgomery's Auditing*, 12thed. (New York: John Wiley & Sons Inc., 1998), p. 28-7.

^{12/} King and Case, "The United States Audit Report," p. 7.

^{13/} Ibid., p. 9.

^{14/} See *Ultramares Corporation v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), in which Judge Cardozo held that an auditor may owe a duty of care to third parties in privity with the firm.

^{15/} Geiger, *The New Auditor's Report*, p. 15.

^{16/} Ibid., p. 17.

report quality and misunderstandings due to ambiguous or vague wordings, and (2) make qualifications in audit reports more easily recognizable."^{17/}

In 1941, a Securities and Exchange Commission ("SEC" or "Commission") investigation of McKesson & Robbins resulted in the issuance of *Accounting Series Release No. 21*.^{18/} This release amended Regulation S-X to require changes in the auditor's report to "state whether the audit was made in accordance with generally accepted auditing standards [("GAAS")] applicable in the circumstances."^{19/} The AIA formally adopted the GAAS standards in 1948 resulting in several revisions to the auditor's report.^{20/} These revisions were purportedly "due to the profession's perception that the audit process was considerably better understood by the public in 1948 than it had been in the past."^{21/}

In 1979, based on recommendations from the Commission on Auditors' Responsibilities ("Cohen Commission"),^{22/} the AICPA's Auditing Standards Board ("ASB") analyzed the standard auditor's report and concluded that "a substantial

^{17/} D.R. Carmichael and A.J. Winters, "The evolution of audit reporting," *Proceedings of the 1982 Touche Ross/University of Kansas Symposium on Auditing Problems* (Lawrence, KS: University of Kansas, 1982), p. 6.

^{18/} For a summary of the findings and conclusions in the Commission investigation, see *In the Matter of McKesson & Robbins, Inc.*, Accounting Series Release No. 19; SEC Release No. 34-2707 (December 5, 1940).

^{19/} Accounting Series Release No. 21; SEC Release Nos. 33-2460 and 34-2776 (Feb. 5, 1941).

^{20/} D.R. Carmichael and A.J. Winters, "The evolution of audit reporting," pp. 20-21. For example, "[r]eference to review of internal control, lack of 'making a detailed audit of transactions,' and 'other supporting evidence' were all deleted in the new report."

^{21/} *Ibid.*, p. 22.

^{22/} In response to congressional and public scrutiny of the accounting profession, the Cohen Commission was established to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors." The Cohen Commission was directed to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish." Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (New York: 1978), p. xi.

departure from the existing report, as suggested by CAR [the Cohen Commission] was not needed."^{23/} The Cohen Commission specifically recommended expanding the auditor's report to include a discussion about four distinct areas – (1) financial statements, (2) other financial information (un-audited), (3) internal control, and (4) other matters (such as the company's policy statement on employee conduct and meetings with the audit committee) – and to have the auditor describe those areas using a series of standardized alternative phrases or paragraphs.

In 1985, in the midst of congressional hearings and the commencement of the National Commission on Fraudulent Financial Reporting ("Treadway Commission"),^{24/} the ASB again indicated that it would "reexamine auditor responsibilities in regard to fraud detection and the related 'expectations gap' between auditors and financial statement users."^{25/} The analysis resulted in the addition of a new paragraph to the auditor's report. This additional paragraph, commonly referred to as the "scope paragraph," states the respective responsibilities of management and the independent auditor, describes the work performed by the auditor, explains the limitation of an audit, and emphasizes the

^{23/} Geiger, *The New Auditor's Report*, p. 31.

^{24/} The Treadway Commission was established in response to the congressional and public scrutiny of the accounting profession after significant business failures such as Drysdale Government Securities, Washington Public Power Supply System, Baldwin-United Corp, and E.S.M. Government Securities [SEC, "The Treadway Commission Report: Two Years Later," News Release (January 26, 1989)]. From October 1985 to September 1987, the Treadway Commission studied the financial reporting system in the United States. The Treadway Commission's mission "was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." *Report of National Commission on Fraudulent Financial Reporting* (October 1987), p. 1.

^{25/} Geiger, *The New Auditor's Report*, p. 36. The phrase "audit expectations gap" was first introduced more than 35 years ago, by C.D. Liggio, who described it as "the difference between the levels of expected performance as envisioned by the independent accountant and by the user of financial statements." See C.D. Liggio, "The Expectation Gap: The Accountant's Waterloo," *Journal of Contemporary Business*, 3, No. 3 (1974), p. 27, noted in Bernard Pierce and Mary Kilcommins, "The Audit Expectations Gap: The Role of Auditing Education," *DCUBS Research Papers* 13 (1995-1996), available at: http://www.dcu.ie/dcubs/research_papers/no13.htm; see also John E. McEnroe and Stanley C. Martens, "Auditors' and Investors' Perceptions of the 'Expectation Gap'," *Accounting Horizons*, 15, No. 4 (2001), pp. 345-358.

fact that sufficient evidence is gathered to provide a reasonable basis for the auditor's opinion.

In 1995, updates to the auditing standards provided auditors with additional guidance regarding the use of emphasis paragraphs, uncertainties, and disclaimers of opinions.

In April 2003, the PCAOB adopted AU sec. 508, *Reports on Audited Financial Statements*, as part of its interim auditing standards. AU sec. 508 sets forth the elements to be included in the auditor's report in connection with audits of financial statements.^{26/} In December 2003, the Board adopted PCAOB Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board*, that requires the auditor's report to state that the audit is conducted in accordance with the standards of the PCAOB when opining on an audit of an issuer.^{27/}

Recommendations Regarding Improving the Auditor's Reporting Model

In October 2007, the U.S. Department of the Treasury established ACAP to "examine auditing industry concentration, financial soundness, audit quality, employee recruitment and retention, in addition to other topics."^{28/} In addressing "the sustainability of the auditing profession," ACAP sought input on and considered a number of matters relating to auditing firms, including "the investing public's understanding of auditors' responsibilities and communications" and "the limitations of audits, particularly relating to fraud detection and prevention."^{29/}

^{26/} See AU sec. 508.08. Also see Appendix A for excerpts of AU sec. 508 pertaining to the basic elements of the standard auditor's report.

^{27/} See Appendix A for an illustrative example of an auditor's standard report on an audit of financial statements according to PCAOB standards. Additionally, PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, prescribes the content of an auditor's opinion on the effectiveness of the company's internal control over financial reporting for those companies that are subject to Section 404(b) of the Sarbanes-Oxley Act of 2002.

^{28/} U.S. Department of the Treasury, "Paulson Announces Auditing Committee Members to Make Recommendations for a More Sustainable, Transparent Industry," Treasury Press Release No. hp-585 (October 2, 2007), available at: <http://www.treas.gov/press/releases/hp585.htm>.

^{29/} ACAP Final Report, p. VII:1.

In October 2008, ACAP released its report recommending that the PCAOB undertake a standard-setting initiative to consider changes to the auditor's standard reporting model because the "standardized wording [of the standard auditor's report] does not adequately reflect the amount of auditor work and judgment."^{30/} One reason ACAP cited for suggesting changes to the content of the audit report is that "the increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value measurements...."^{31/} ACAP stated that the current pass/fail auditor's reporting model^{32/} could be improved to include "a more relevant discussion about the audit of the financial statements," and heard testimony that some institutional investors "recommend exploring a more 'narrative' report in areas such as 'estimates, judgments, sufficiency of evidence and uncertainties'.^{33/} ACAP also stated that this additional discussion would "enhance investor confidence in financial reporting" and "clarify the role of the auditor in the financial statement audit."^{34/} ACAP acknowledged the need for additional research to determine "precisely what additional information is sought by and would be useful to investors and other users of financial statements."^{35/}

ACAP also recommended that the PCAOB and the SEC "clarify in the auditor's report the auditor's role and limitations in detecting fraud under current auditing standards."^{36/} ACAP noted that the current standard auditor's report does not mention fraud. ACAP recommended "expressly communicating to investors, other financial statement users, and the public the role of auditors in finding and reporting fraud."^{37/} ACAP also recommended that the PCAOB "review

^{30/} Ibid., p. VII:14.

^{31/} Ibid., p. VII:17.

^{32/} "Many consider the auditor's reporting model a pass/fail model because the auditor opines whether the statements are fairly presented (pass) or not (fail)." See ACAP Final Report, p. VII:13.

^{33/} Ibid., p. VII:17.

^{34/} Ibid.

^{35/} Ibid.

^{36/} Ibid., p. VII:18.

^{37/} Ibid.

and update the auditing standards governing fraud detection and fraud reporting."^{38/}

In September 2009, the Technical Committee of the International Organization of Securities Commissions ("IOSCO") published a consultation report, *Auditor Communications*, seeking comment on whether changes to the standard auditor's report or additional auditor communications are needed to meet investor information needs.^{39/} Auditors and associations of accountants commented that the current auditor's report clearly communicates the auditor's opinion in a recognized form and that the auditor's report is not the appropriate place for statements relating to the quality of the financial statements, management's processes or other information regarding the company.^{40/} Auditors stated that the more appropriate source for such information is management or audit committees. The Canadian Public Accountability Board commented that the current auditor's report is useful to investors and that a change from the pass/fail model may be more confusing for investors and may make it more difficult to understand whether the financial statements are presented fairly.^{41/}

Institutional Investors and the Dubai Financial Services Authority, on the other hand, stated that the current reporting model does not reflect the growing complexity in business, financial reporting, and auditing and that it would be worthwhile to include information on the audit process (what the auditor actually did) and the quality of the financial statements.^{42/} These commenters stated that

^{38/} Ibid., pp. VII:18-19.

^{39/} Technical Committee of the International Organization of Securities Commissions ("IOSCO"), *Auditor Communications Consultation Report* (September 2009), available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD303.pdf>. See also IOSCO *Auditor Communications Consultation Report Comment Letters* (February 2010), available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD316.pdf>. IOSCO received 22 comment letters, including 14 comment letters from auditors and associations of accountants, three comment letters from institutional investors, three comment letters from regulators and two comment letters from standard setters.

^{40/} See comment letters in response to IOSCO, *Auditor Communications*, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD316.pdf>.

^{41/} Ibid.

^{42/} Ibid.

management and the auditor should work together to provide information collectively.

Discussion Topics

I. The Standard Auditor's Report

The standard auditor's report identifies the financial statements audited in an opening paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. AU sec. 508 describes four different types of reports – unqualified opinion, qualified opinion, adverse opinion, and a disclaimer of opinion.^{43/} An unqualified opinion (typically referred to as the standard auditor's report) states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP. Although AU sec. 508 provides for different types of audit reports, the SEC staff does not accept qualified opinions as being in compliance with the Commission's rules;^{44/} audit reports filed with the Commission therefore generally must include an unqualified opinion indicating that the company's financial statements are presented fairly (the "pass" determination in the pass/fail model).

In February 2005, the Board sought the SAG's input regarding the advantages and disadvantages of the current reporting model and also whether there is a need for a different form of auditor reporting other than the pass/fail model.^{45/} SAG members responses were mixed. Some SAG members expressed preference for the current pass/fail model stating that it is "clear," "simple," "consistent," "comparable," and "easy for the investing public to digest." Other SAG members stated that the current auditor's reporting model is "very routine,"

^{43/} The International Auditing and Assurance Standards Board ("IAASB") has an analogous auditing standard, International Standard on Auditing ("ISA") 700, *Forming an Opinion and Reporting on Financial Statements*. See Appendix B for an example of the IAASB's standard auditor's report as required by ISA 700.

^{44/} SEC Staff Accounting Bulletin: Topic 1E2, *Requirements For Audited Or Certified Financial Statements*.

^{45/} See February 16, 2005 SAG briefing paper at: http://pcaobus.org/News/Events/Documents/02162005_SAGMeeting/Auditors%20Reporting%20Model.pdf.

"sort of a boiler plate," "information content is minimal," and that the "current model does not allow for ranges within the unqualified ["pass"] opinion."^{46/}

A. Content of the Auditor's Report

Recent research indicates that while users find the auditor's report to be important, they have very little interest in reading the actual content of the auditor's report – "CFOs, bankers and analyst groups indicate [that] they look at the auditor's report only to see if there is an unqualified opinion and which audit firm signed the report."^{47/} This finding is consistent with prior academic research which indicated that "the auditor's report evolved to represent a symbol of the auditor's work rather than a substantive communication to users."^{48/}

Those who prefer the pass/fail model state that the scope paragraph in the auditor's report is meant to explain to the users that the auditor's opinion encompasses the auditor's compliance with all of the Board's auditing and related professional practice standards.

In 1978, the Cohen Commission stated that a movement away from identical boilerplate language would result in users devoting greater attention to the content in the auditor's report.^{49/} In October 2008, the ACAP Final Report cited a February 2008 CFA Institute survey "which indicated that 80 percent of its member respondents believe that the auditor's report should provide specific information about how the auditor reached its opinion."^{50/} Specifically, survey respondents thought that auditors should "identify key risk areas, significant changes in risk exposures, and amounts either involving a high degree of

^{46/} See February 16, 2005 SAG Webcast at: http://pcaobus.org/News/Webcasts/Pages/02162005_SAGMeeting.aspx.

^{47/} Mock et al., *The Unqualified Auditor's Report: A Study of User Perceptions, Effects on User Decisions and Decision Processes, and Directions for Further Research* (unpublished report to the Auditing American Institute of Certified Public Accountants Standards Board and the International Auditing and Assurance Standards Board, New York, 2009), p.6., available at: http://www.fdewb.unimaas.nl/ISAR2009/02_13_Mock_Turner_Gray_Coram.pdf.

^{48/} Church, et al., "The Auditor's Reporting Model: A Literature Overview and Research Synthesis, *Accounting Horizons*, 22, No. 1 (2008), p. 74.

^{49/} Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (New York, 1978), p. 75.

^{50/} ACAP Final Report, p. VII:16.

uncertainty in measurement and significant assumptions or requiring a higher level of professional judgment."^{51/} In 2007, panelists at an IOSCO roundtable shared a similar view of the auditor's report. Specifically, panelists suggested that the binary nature of the auditor's opinion may not be optimal for today's complex business environment and that the report should specifically identify issues that the auditor uncovered during the course of the audit.^{52/}

A starting point some have recommended in considering changes to the auditor's report is to incorporate elements of certain communications the auditor is required to have with an audit client's audit committee into the auditor's report. For example, AU sec. 380, *Communication With Audit Committees*, requires the auditor to discuss with the audit committee the auditor's judgments regarding the quality, and not just the acceptability, of a company's accounting principles.^{53/} AU sec. 380 states that the discussion should "include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements,"^{54/} such as estimates, judgments, and uncertainties; unusual transactions; selection of new or changes to accounting policies; and accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded. AU sec. 380 also directs the auditor to "determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates."^{55/}

During the Auditor's Reporting Model discussion at the February 2005 SAG meeting, some SAG members suggested that including information discussed between the auditor and audit committee in an emphasis paragraph would be an improvement to the current auditor's reporting model.^{56/} Other SAG members suggested adding an appendix to the current auditor's report to include

^{51/} Ibid.

^{52/} IOSCO, *Auditor Communications*, p. 1.

^{53/} AU sec. 380.11.

^{54/} Ibid.

^{55/} AU sec. 380.08.

^{56/} See February 16, 2005 SAG Webcast at: http://pcaobus.org/News/Webcasts/Pages/02162005_SAGMeeting.aspx.

additional information that might be useful to investors, such as a description about the audit procedures performed for certain areas.^{57/}

AU sec. 380 allows the auditor to communicate with the audit committee orally or in writing.^{58/} At the October 2009 SAG meeting discussion regarding communications with audit committees, several SAG members cautioned the Board against requiring the communications with audit committees to be solely in writing because it might result in the communications becoming standardized and boilerplate.^{59/} Some have indicated that if certain information the auditor is required to provide to the audit committee is included in the auditor's report or a supplemental document to the auditor's report (disclosed publicly), such disclosure may have a negative effect on the audit committee communications because the dialogue between the auditor and the audit committee may become less forthright and transparent.^{60/}

Several countries have amended their auditor's reports to include additional information.^{61/} For example, in Germany, auditors of "public companies are generally required to issue a long-form auditor's report, discussing matters such as the company's economic position and trend of business operations and the nature and scope of the auditor's procedures."^{62/} Additionally, French law requires the auditor's report to contain a "justification of the auditor's assessments."^{63/} The auditor is required, in an explanatory paragraph, to explain

^{57/} Ibid.

^{58/} AU sec. 380.03.

^{59/} See October 14-15, 2009 SAG Webcast at: http://pcaobus.org/News/Webcasts/Pages/10142009_SAGMeeting.aspx.

^{60/} For example, see Canadian Public Accountability Board comment letter in response to IOSCO, *Auditor Communications*, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD316.pdf>.

^{61/} Different foreign jurisdictions have varying legal and liability environments which may impact the type and amount of additional information that is included in the auditor's report.

^{62/} ACAP Final Report, p. VII:16-17. See Appendix B for an illustration of a statutory auditor's report currently used in Germany.

^{63/} See Compagnie Nationale des Commissaires aux Comptes ("CNCC") comment letter in response to IOSCO, *Auditor Communications*, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD316.pdf>; Also

the procedures the auditor performed with respect to relevant areas of the audit, such as accounting policies, accounting estimates, and overall presentation of the financial statements.^{64/} Each justification of the auditor's assessment must reference a specific disclosure contained in the audited financial statements. The justifications cannot provide company information that the company has not disclosed; each justification is "anchored to a note to the financial statements."^{65/}

In the United Kingdom, the standard auditor's report was also recently revised as a result of the Companies Act of 2006.^{66/} The Companies Act of 2006 requires auditors to provide a three-part opinion in which the auditor must state whether the annual accounts (a) give a true and fair view of the state of affairs of the company; (b) are properly prepared in accordance with the relevant financial reporting framework; and (c) are prepared in accordance with the requirements of the Companies Act of 2006. These new requirements differ from the previously required auditor's opinion that only required the auditor to give an opinion as to whether the annual accounts gave a true and fair view, in accordance with the relevant financial reporting framework, of the state of affairs and profit or loss for the year. Also, in Japan, the standard auditor's report has been modified to

described in IAASB, Auditor's Report – IAASB Working Group Report ("IAASB Working Group Report") Agenda Item 4-A, pp. 4-5 (December 2009), available at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0169&ViewCat=119>. See Appendix B for an illustration of a statutory auditor's report currently used in France.

^{64/} The IAASB's Working Group Report on the auditor's reporting model stated that one noted drawback of the French model is that over time the wording used in the "justification of the auditor's assessments" section of the report over successive years has been simply repeated and has become a bit boilerplate. IAASB agenda materials are available at: <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0169&ViewCat=119>.

^{65/} See CNCC comment letter in response to IOSCO, *Auditor Communications*, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD316.pdf>. The IAASB Working Group Report, p.5, also stated that "justifications do not constitute a piecemeal opinion and the auditor's opinion is on the financial statements taken as a whole."

^{66/} See Appendix B for an illustration of a statutory auditor's report currently used in United Kingdom.

provide an additional paragraph disclosing the existence of any conflict of interest between the audited company and the auditor or the engagement partner.^{67/}

Discussion Questions –

1. What are the benefits and shortcomings of the current auditor's reporting model? In what areas could the current auditor's report be enhanced (e.g., description of auditor's responsibilities, description of auditor's procedures, or description of management's and audit committee's responsibilities)?
2. Should the auditor's report discuss certain information the auditor is required to provide to the audit committee about the auditor's assessment of the quality of the financial statements (e.g., the auditor's judgments relating to management's selection of new or changes to existing accounting policies; accounting estimates, judgments and uncertainties; unusual transactions; and accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded)?
3. Should the auditor's report include a description of the procedures the auditor performed in reaching his/her conclusion that the financial statements are presented fairly? If yes, how could such a report add value beyond a discussion of the requirements of the PCAOB standards that the auditor applied to form his or her opinion?

B. Form of the Auditor's Report

In addition to enhancing the content of the standard auditor's report, some have recommended enhancing the form of the auditor's report as well.

Emphasis of a matter

AU sec. 508 allows the auditor, at his or her discretion, to include an explanatory paragraph in the auditor's report to emphasize a matter regarding the financial statements, such as significant transactions with related parties and unusually important subsequent events.^{68/} One option to changing the auditor's

^{67/} See Appendix B for an illustration of a statutory auditor's report currently used in Japan.

^{68/} AU sec. 508.19.

report could be to require auditors to disclose additional information as part of an additional emphasis paragraph in the auditor's report.

Long form

Another option, as recommended by the Cohen Commission, is to expand the auditor's report to include the content relating to the auditor's and management's significant judgments, thereby creating a long-form report. According to a feedback paper on the auditor's report, management is, however, generally not supportive of adding more company-specific information to the auditor's report on the grounds that the financial statements should be the primary location that contains all relevant financial disclosures and that it is not appropriate to make explicit statements about management's application of accounting principles in the auditor's report.^{69/} One way to avoid this conflict is to follow the French model that provides a reference to the financial statement disclosures for any items specifically noted in the auditor's report.

Supplemental Disclosure Document – Auditor's Discussion and Analysis

Some have suggested that instead of creating a long-form report the current pass/fail model should be retained and a requirement added for a supplemental report by the auditor that would present a discussion about the judgments made by the auditor and the auditor's views regarding judgments made by management. The supplemental report would be akin to the management discussion and analysis (MD&A) section of a company's annual report. This option would provide investors and other users of financial statements with the flexibility to quickly identify the auditor's opinion and also give them the opportunity to find out more information regarding the auditor's judgments and the auditor's thoughts regarding judgments made by management. This suggested supplemental report is sometimes referred to as the Auditor's Discussion and Analysis ("AD&A").

Varying levels of assurance

Academic research indicates that the current accounting model creates confusion as to the reliability of the financial statement line-item amounts

^{69/} Feedback paper on "The Auditor's Report: A time for change?" Discussion Paper and APB Future Plans Regarding the Form and Content of UK Auditor's Reports, available at: <http://www.frc.org.uk/images/uploaded/documents/Feedback%20Paper%20on%20Discussion%20Paper%20The%20Auditor's%20Report%20-%20A%20Time%20for%20Change.pdf>.

because it does not permit users to distinguish between facts (i.e., transactions without uncertainty) and forecasts (i.e., transactions with uncertainty).^{70/}

In November 2003, the American Assembly issued a report ("American Assembly Report") recommending that a new kind of financial reporting model be implemented with a new kind of audit opinion.^{71/} The American Assembly Report states on page 12:

We envision the balance sheet of the future containing line items similar or identical to those used today by companies and within specific industries, including comparisons to prior years. But this new balance sheet would permit the display of different kinds of numbers – either in a range, or presented as alternatives. This approach could be used to portray cash transactions for which audit assurance is highest, the historical cost allocations of prior cash transactions, market values from actual arms'-length transactions, where available, or other market pricing mechanisms, as well as estimated fair values when no reliable market pricing mechanism exists. The result of such a change in approach, we believe, would be to offer investors a broader array of information.

The American Assembly Report suggested a "new and more flexible approach to preparing financial statements" to allow companies and their auditors to fairly present this inherent uncertainty.^{72/} In addition, the American Assembly Report suggested that such a change in approach would offer investors a broader array of information.

To compliment a possible new approach to preparing financial statements, the American Assembly Report also recommended a new kind of audit opinion that would allow for varying levels of assurance for different parts of the financial statements. The American Assembly Report suggested that the current auditing model is appropriate for "concrete non-speculative aspects" of financial statements, such as those for which historical cost is an adequate accounting metric," but would have to be changed for financial statement line items that are

^{70/} Glover, et al., "Separating Facts from Forecasts in Financial Statements," *Accounting Horizons* 19, No. 4 (December 2005), pp. 267-283.

^{71/} The 103rd American Assembly, "The Future of the Accounting Profession" (New York: The American Assembly, Columbia University, November 13-15, 2003).

^{72/} *Ibid.*, p. 12.

subject to judgments by management and auditors.^{73/} For these "speculative" items, the American Assembly Report recommended that auditors give significantly more limited attestation. The American Assembly Report further recommended that expectations regarding the exactitude of the financial statements and what the audit opinion means should change to reflect the varying degrees of attestation.^{74/}

In February 2005, the Board sought the SAG's input regarding whether the auditor's reporting model should be revised to provide differing levels of assurance^{75/} on different parts of the financial statements.^{76/} Generally, the SAG members stated that providing varying levels of assurance on different parts of the financial statements would not be appropriate.^{77/} Instead, they suggested adoption of a multi-range grading system that would provide a range of grades within the "pass" category. Those SAG members stated that this range would add more transparency into the auditor's process and also inform investors of the level of risks taken by the company. SAG members also stated that a multi-range grading system would provide companies with an incentive to engage in less aggressive and more straightforward accounting.

Discussion Questions –

4. Should the form of the auditor's report:
 - a. Require the auditor to disclose additional information in the emphasis paragraph?
 - b. Include information relating to the auditor's and management's significant judgments, thereby creating a long-form report?

^{73/} Ibid.

^{74/} Ibid., p. 14.

^{75/} The terms "varying" or "differing" when describing levels of assurance are used interchangeably.

^{76/} See February 16, 2005 SAG briefing paper at: http://pcaobus.org/News/Events/Documents/02162005_SAGMeeting/Auditors%20Reporting%20Model.pdf.

^{77/} See February 16, 2005 Webcast at: http://pcaobus.org/News/Webcasts/Pages/02162005_SAGMeeting.aspx.

- c. Incorporate a roadmap referencing certain financial statement disclosures in the auditor's report? If so, what criteria should be created to assist auditors in determining which significant accounting estimates and judgments made by management to highlight?

What are the benefits and shortcomings of these potential audit report forms?

5. Should the current pass/fail model be retained and a requirement added for a supplemental report by the auditor that would discuss the judgments made by the auditor and the auditor's views regarding judgments made by management, i.e., an Auditor's Discussion and Analysis? What are the benefits and shortcomings of an AD&A supplemental report?
6. Given the changes in the current economic environment resulting from the recent market crisis and its implications (such as difficulty in valuing illiquid instruments), have the SAG members' views changed regarding whether the auditor's report should be expanded to provide varying degrees of assurance depending on the degree of estimation and uncertainty of each financial statement line item?
7. If the auditor's report were to be expanded to allow for a multi-grading system, what grading criteria could auditors use?

II. The Auditor's Responsibility in Detecting Fraud

A. Auditor's Responsibility for Detecting Fraud as Described in the Auditor's Report

The Board's auditing standards require the auditor to plan and perform the audit "to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."^{78/} AU sec. 310, *Appointment of the Independent Auditor*, states that "[a]lthough not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance."^{79/}

^{78/} Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*, paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*, paragraph .06 of AU sec. 310, *Appointment of the Independent Auditor*, and paragraphs .01 and .12 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*.

^{79/} AU sec. 310.06.

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, states that "absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud."^{80/}

AU sec. 508 requires the auditor to state in the auditor's report that the auditor planned and performed the audit "to obtain reasonable assurance about whether the financial statements are free of material misstatement."^{81/} The statement in the auditor's report does not include the language "whether caused by fraud or error" that is part of the information identified above in AU sec. 316 when describing the auditor's responsibility.

The ACAP Final Report stated that "[i]t is noteworthy that the current standard auditor's report does not actually mention fraud and is silent about the auditor's responsibilities to *find* fraud."^{82/} ACAP recommended that "the auditor's report should articulate clearly to investors the auditor's role and limitations in detecting fraud."^{83/}

Discussion Questions –

8. The ACAP recommendation suggests that the auditor's report should articulate the "auditor's role and limitations in detecting fraud." Would adding
 - i. the phrase "whether caused by fraud or error" and
 - ii. the concept that the audit is based on the auditor obtaining reasonable assurance, which is a high level of assurance, and not absolute assurance adapted from PCAOB auditing standards

to the standard auditor's report when describing the auditor's responsibility be a meaningful addition to the report? What other suggested language might assist in describing in the auditor's report the auditor's responsibility with respect to fraud?

^{80/} AU sec. 316.12.

^{81/} AU sec. 508.08.

^{82/} Ibid., p. VII:15.

^{83/} Ibid., p. VII:18.

B. Forensic Audit Procedures

In November 2006, the Global Public Policy Symposium, comprising the CEOs of the six largest accounting firms, released a paper claiming that "there is a significant 'expectations gap' between what various stakeholders believe auditors do or should do in detecting fraud, and what audit networks are actually *capable* of doing, at the prices that companies or investors are willing to pay for audits."^{84/} The authors of the paper proposed certain ideas to change financial statement audits:

- *A forensic audit on a regular basis* – "The most aggressive, but costly and intrusive way of rooting out fraud is to require all public companies to undergo a forensic audit on a regular basis (perhaps every three or five years)"
- *A forensic audit on a random basis* – "A less onerous and less costly version of the forensic audit proposal would be to subject a sample of public companies on every exchange to a forensic audit on a random basis"
- *Other "choice-based" options* – "For example, since forensic audits are conducted primarily for the benefit of investors, one possibility would be to let shareholders decide on the intensity of the fraud detection effort they want auditors to perform. Shareholders could be assisted in making this decision by disclosure in the proxy materials of the costs of the different levels of audits, as well as the historical experience of the company with fraud. A different choice model would be to allow boards, or audit committees ..., to decide on the level of fraud detection intensity."^{85/}

^{84/} Global Policy Symposium, Global Capital Markets and the Global Economy, "A Vision From the CEOs of the International Audit Networks" (November 2006), p. 13, available at: http://www.globalpublicpolicysymposium.com/CEO_Vision.pdf. The Global Public Policy Symposium also released "Global Dialogue with Capital Markets Stakeholders: A Report From the CEOs of the International Audit Networks" (January 2008), available at: http://www.globalpublicpolicysymposium.com/GPPC_Vision.pdf and "Principles-Based Accounting Standards" (January 2008), available at: http://www.globalpublicpolicysymposium.com/GPPC_PBS_White_Paper.pdf.

^{85/} Ibid., p. 13.

In December 2009, the Board re-proposed a suite of seven risk assessment auditing standards for public comment which are intended to, among other things, emphasize the auditor's responsibilities for considering the risk of fraud during the audit and include proposed provisions intended to address identified deficiencies in auditors' compliance with AU sec. 316.^{86/}

Discussion Question –

9. Should the Board amend its auditing standards to require additional audit procedures relating to fraud, adding a forensic audit component to the audit, or another option? If additional audit procedures should be incorporated into the auditing standards, what specific revisions should be made to AU sec. 316?

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

^{86/} PCAOB Release No. 2009-007, *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk* (December 17, 2009); available at: <http://pcaobus.org/Rules/Rulemaking/Pages/Docket026.aspx>. The comment period ended on March 2, 2010.

APPENDIX A

EXCERPTS FROM

**PCAOB INTERIM AUDITING STANDARD,
AU SECTION 508, *REPORTS ON
AUDITED FINANCIAL STATEMENTS***

And

**PCAOB AUDITING STANDARD NO.1,
*REFERENCES IN AUDITOR'S REPORTS
TO THE STANDARDS OF THE PUBLIC
COMPANY ACCOUNTING OVERSIGHT
BOARD***

**Basic Elements of the Standard Auditor's Report – AU sec. 508.08
(footnotes omitted)**

- a. A title that includes the word *independent*
- b. A statement that the financial statements identified in the report were audited
- c. A statement that the financial statements are the responsibility of the Company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit
- d. A statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards)
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement
- f. A statement that an audit includes –
 - (1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements
 - (2) Assessing the accounting principles used and significant estimates made by management
 - (3) Evaluating the overall financial statement presentation
- g. A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion
- h. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting

principles generally accepted in the United States of America or
U.S. generally accepted accounting principles

- i. The manual or printed signature of the auditor's firm
- j. The date of the audit report

Illustrative Example – PCAOB Auditing Standard No.1 (Appendix)

The following is an illustrative report on an audit of financial statements:

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[Signature]

[City and State or Country]

[Date]

APPENDIX B

Illustrative Auditor's Reports

- **International Auditing and Assurance Standards Board's International Standards on Auditing 700, Standard Auditor's Report**
- **Standard Auditor's Report used in United Kingdom**
- **Standard Auditor's Report used in France**
- **Standard Auditor's Report used in Japan**
- **Standard Auditor's Report used in Germany**

IAASB ISA 700^{1/}

Independent Auditor's Report
[Appropriate Addressee]

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheet as at December 31, 20X1, and the consolidated income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an

^{1/} This illustrative standard audit report is included as Illustration #3 in ISA 700 (Redrafted). See <http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=4293>.

opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, (or "*give a true and fair view of*") the financial position of ABC Company and its subsidiaries as (of) December 31, 20X1, and (of) their financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

Notes:

- (1) The sub-title "Report on the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.
- (2) The term "Management's" may be replaced as necessary with the other term that is appropriate in the context of the legal framework in the particular jurisdiction.
- (3) Depending on the circumstances, the sentence that reads, "Management is responsible for the preparation and fair presentation..." may read: "Management is responsible for the preparation and presentation of consolidated financial statements that give a true and fair view in accordance with International Financial Reporting Standards..."
- (4) Depending on the circumstances, the sentence that reads, "In making those risk assessments, the auditor considers internal control relevant to

the entity's preparation and fair presentation..." may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control."

- (5) In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, the sentence that reads, "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control..." would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances." In the case of note 2 above, the sentence may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and presentation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

United Kingdom

Independent Auditor's Report to the [Shareholders] [Members] of XYZ PLC

Report on the financial statements

We have audited the financial statements of (name of entity) for the year ended ... which comprise [specify the financial statements, such as the Group and Parent Income Statements, the Group and Parent Balance Sheets, the Group and Parent Cash Flow Statements, the Group and Parent Statements of Changes in Equity], and the related notes. The financial statements have been prepared in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

In relation to these financial statements, the directors are responsible for their preparation and presentation and for being satisfied that they give a true and fair view.

Our responsibility is to audit the financial statements in accordance with the requirements of the Companies Act 2006 and International Standards on Auditing (UK and Ireland) and to express an opinion on the financial statements. In forming our opinion we are also required to comply with the Auditing Practices Board's Ethical Standards. A statement describing the scope of an audit and the auditor's reporting responsibilities in respect of a United Kingdom publicly traded company is available on the APB's web site [*insert reference to web page*].

Opinion

In our opinion the financial statements:

- have been properly prepared in accordance with IFRSs as adopted by the European Union;
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation; and
- give a true and fair view of the state of the group's and the parent company's affairs as at ... and of the group's and the parent company's profit for the year then ended.

Opinion

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report is consistent with the financial statements.

We also have responsibilities:

- under the Companies Act 2006 to report to you if, in our opinion:
 - Adequate accounting records have not been kept, or that returns adequate for our audit have not been received from branches not visited by us.
 - The parent company financial statements are not in agreement with the accounting records and returns.
 - The part of the Directors' Remuneration Report to be audited is not in agreement with the accounting records and returns.
 - We have not received all the information and explanations we require for our audit.
- under the Listing Rules of the Financial Services Authority, to review:
 - The statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary.
 - The parts of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the [2006]/[June 2008] Combined Code specified for our review.

We have nothing to report to you in respect of these responsibilities.

[Signature] Address
John Smith (Senior statutory auditor) Date
for and on behalf of ABC LLP, Statutory Auditor

Notes:

- (1) At present two versions of the Combined Code are in effect. The 2006 edition applies to accounting periods beginning on or after 1 November 2006 and the June 2008 edition applies to accounting periods beginning on or after 29 June 2008.

France

Statutory Auditors' Report on the Consolidated Financial Statements

Following our appointment as Statutory Auditors by your Annual General Meeting, we have audited the accompanying consolidated financial statements of XYZ company for the year ended 31 December 2005. The consolidated financial statements have been approved by the Managing Board. Our role is to express an opinion on these financial statements based on our audit. These financial statements have been prepared in accordance with IFRSs as adopted for use in the European Union. They include comparative information restated in accordance with the same standards in respect of the financial year 2004.

Opinion on the consolidated financial statements

We conducted our audit in accordance with professional standards applicable in France. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the assets and liabilities and of the financial position of the [Group] as at 31 December 2005 and of the results of its operations for the year then ended in accordance with IFRSs as adopted for use in the European Union.

Justification of our assessments

In accordance with the requirements of article L. 823-9 of the French Commercial Law relating to the justification of our assessments, we bring to your attention the following matters:

- Regarding the first time adoption of IFRS to prepare the 2005 consolidated financial statements, note 44 sets out all the disclosures required concerning the change in accounting standards at 1 January 2004 and describes the steps taken to ensure that the financial statements presented for 2005 and 2004 in accordance with IFRS are comparable. As part of our assessment of the accounting principles and methods applied, we verified, in

particular, the correct application of the method used to record development expenditure within assets (note 1.11A), as well as the amortization method applied in view of the revised useful life of vehicle projects, which is now capped at seven years (Note 44.1A), and the method of testing the recoverable amount of these assets (note 1.13). We also verified the correct calculation of the adjustments in respect of sales subject to a buyback commitment (note 1.5.Aa) in view of the increased accuracy resulting from the new IT programs developed for this purpose (note 44.1.A), and that any other changes described in this note were appropriate.

- As indicated in note 1.10, goodwill is no longer amortized but is tested for impairment at least annually according to the method set out in note 1.13. In 2005, impairment tests conducted by the Automotive Equipment Division, as described in note 8.1, led to a write-down of 180 million euros on assets assigned to the vehicle interior systems and modules segment. As part of our assessment of the significant estimates made by management, we verified that this approach complied with IFRS and that the impairment tests described in the notes to the consolidated financial statements were carried out correctly. We also assessed whether the cash flow projections applied and other assumptions used were reasonable. These assessments were made in the context of our audit of the consolidated financial statements taken as a whole, and therefore contributed to the opinion we formed which is expressed in the first part of this report.

Specific verification

In accordance with professional standards applicable in France, we have also verified the information given in the Group's management report. We have no matters to report as to its fair presentation and its consistency with the consolidated financial statements.

Address	Date
Firm 1	Lead Statutory Auditor
Firm 2	Statutory Auditor

Japan

Independent Auditors' Report
[To the Board of Directors of ABC Corporation]

We have audited the accompanying consolidated balance sheets of ABC Corporation and consolidated subsidiaries as of March 31, 20X5 and 20X4, and the related consolidated statements of income, shareholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to independently express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ABC Corporation and consolidated subsidiaries as of March 31, 20X5 and 20X4, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles and practices generally accepted in Japan.

There is no conflict of interest between the Company and us or the engagement partner that should be stated in the report as required by the CPA Act.

XYZ Audit Corporation

June XX, 20X5

Germany

We have audited the consolidated financial statements prepared by (name of audit firm), comprising the income statement, balance sheet, cash flow statement, statement of recognized income and expense, and the notes to the consolidated financial statements, together with the Group management report for the financial year from January 1 to December 31, 2008. The preparation of the consolidated financial statements and the Group management report in accordance with the IFRS, as adopted by the EU, and the additional requirements of German commercial law pursuant to § 315a (1) of the German Commercial Code (Handelsgesetzbuch – HGB) are the responsibility of the parent Company's Board of Management. Our responsibility is to express an opinion on the consolidated financial statements and on the Group management report based on our audit. In addition, we have been instructed to express an opinion as to whether the consolidated financial statements comply with IFRS as issued by the IASB.

We conducted our audit of the consolidated financial statements in accordance with § 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer – IDW) and additionally observed the International Standards on Auditing (ISA). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the Group management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the Group management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of the entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by the Company's Board of Management, as well as evaluating the overall presentation of the consolidated financial statements and the Group management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on our findings of our audit, the consolidated financial statements comply with the IFRS as adopted by the EU, the additional requirements of German commercial law pursuant to § 315a (1) HGB and IFRS as issued by the IASB, and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The Group management report is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group's position and suitably presents the opportunities and risks of future development.

Address	Date
Audit Firm 1	Lead Statutory Auditor
Audit Firm 2	Statutory Auditor