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Mr. Steve Ong
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Hong Kong Institute of Certified Public Accountants
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Dear Steve,

International Auditing and Assurance Standards Board ("IAASB") Consultation Paper on Enhancing the Value of Auditor Reporting: Exploring Options for Change ("Consultation Paper")

We have completed our review of the Consultation Paper which seeks views on the current auditor reporting model and in particular views on possible improvements that can be made to the form and content of audit reports.

Our comments on the Consultation Paper are set out below.

<u>Objective and scope of an audit</u>

We believe that before considering how to improve the current auditor reporting model it is necessary to first address the key issues of what is the objective of an audit and the boundaries of information covered by the report.

We note that currently the objective of an audit is to provide an independent opinion on whether the financial statements prepared by management in fact do show a true and fair view. The scope of an audit is primarily limited to historical financial information and "actual" historical transactions, but we note that financial reporting standards issued by the International Accounting Standards Board ("IASB") introduce elements of recognising hypothetical "as if" transactions through the wider recognition of fair value re-measurements of assets and liabilities.

Users of financial statements expect that the audit opinion provides them with a level of assurance on the reported results and financial position of the reporting entity so that they are able to make better informed investment decisions. We believe that users may also be seeking information on the future viability of the entity and the

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stewardship of management, that is, the efficiency or effectiveness of management in conducting the affairs of the entity. The 2008 financial crisis also gave rise to questions on the role of an audit in the early detection and reporting of expected losses and the possibility of company failure.

We believe that before considering improvements to be made to audit reports, the scope of the subject matter on which the auditor reports must be clearly defined. We have previously raised this issue in our letter to the Institute dated 7 June 2011 on "*IFRS Foundation Report of the Trustees' Strategy Review – IFRSs as the Global Standard: Setting a Strategy for the Foundation's Second Decade*" where we commented that it is necessary to distinguish "financial reporting" from "financial statements". "Financial reporting" is much wider than "financial statements" and currently the IASB only issues standards on information to be included in "financial statements".

As a result, at present auditors only report on the information included in the financial statements. However, for financial statements to meaningful we believe they should include as an integral component a narrative Management Discussion and Analysis ("MD&A") which is aimed at explaining the quantitative data provided in the financial statements. Currently, although the MD&A is not directly within the scope of an audit, it provides a useful narrative of the significant events and transactions that had affected the performance and financial position of the entity.

We believe users need to have confidence in the integrity of both the quantitative financial information and the MD&A which contributes to explaining how the directors have discharged some of their stewardship responsibilities. We therefore believe that the MD&A should be incorporated and form part of the financial statements and thus should be covered by the audit report. We note that International Standard on Auditing ("ISA") No. 720 on "*The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*" already requires the auditor to review information included outside the financial statements, and this recommendation would be an extension to provide clarity and further codify the requirement.

To implement the above recommendation that the MD&A should form an integral part of the financial statements will require a change in the standards issued by the IASB. We therefore believe that the IAASB could adopt a phased approach. In the first phase, it could consider how the audit report could be enhanced based on the existing disclosures required in financial statements. In the second phase, the IAASB could consider the wider role of the auditor to cover the MD&A.

Given the move towards "Integrated Reporting", which we understand is an attempt to provide a more holistic approach of communication between an entity and its stakeholders, we believe that auditors will be expected to play a wider role and provide assurance on other aspects of an entity's business. In the second phase, the requests to provide assurance on other non-financial matters would likely involve separate assurance engagements, and the form and content of these reports will need to be considered and developed separately.

<u>Impact of accounting standards</u>

We agree with the IAASB's observation that currently there is an information gap and *"the information gap is partially attributable to weaknesses in the financial reporting frameworks or their application"*.

In the past, an audit was primarily focused on examining past "actual" transactions to ensure their impact was properly recorded and reflected in the financial statements. However, recent accounting standards are increasingly requiring fair value re-measurements.

Fair value re-measurements represent the recognition of "hypothetical transactions" with "hypothetical parties" and at "hypothetical exit prices". Due to their nature these re-measurements are very subjective and prone to significant error. Preparers are required to exercise significant judgements in valuing assets and liabilities to fair value. In particular, inputs for fair value measurements made under hierarchy Level 3 are based entirely on models and assumptions which we believe are not auditable. Any one of the assumptions adopted may be invalid, which in turn may have a significant impact on the entity's reported results and financial position.

We believe fair value information can be more easily manipulated as external third party evidence to support it is not always available. As a result, fair value accounting intensifies the expectation gap between users and auditors, and auditors will be challenged on the reliability and sufficiency of evidence to support the fair values recognised.

This leads to the fundamental question of what information and where the information should reside in financial statements. That is, should fair value re-measurements which represent hypothetical transactions be recognised in measuring the performance and financial position of an entity. The answer to the question has an impact on the audit opinion that can be given and thus the form and content of the audit report.

As explained in our letter to the Institute dated 8 June 2011 on the IAASB discussion paper on "*Evolving Nature of Financial Reporting: Disclosure and its Audit Implications*", we believe that "auditability" issues arise from the increasing use of fair values and the detailed and complex disclosures imposed under IFRS. For example, the disclosures required under IFRS 7 are voluminous and many additional disclosures are made because of the complexity and subjectivity involved in accounting for financial instruments and other assets at fair value. Our concerns are on "upward" revaluation of assets above their original cost on acquisition. We have less concerns with "downward" revaluations and believe downward adjustments are appropriate as they represent the recognition of expected losses on "actual" transactions that have been previously recognised to their recoverable values. The downward adjustments implement the underlying principle that assets should not be overstated and liabilities should not be understated.

Because accounting and auditing is intricately linked, we believe that there should be closer liaison and interaction between the IAASB and IASB to ensure that the disclosures required in financial statements as determined by the IASB are capable of being audited.

Suggestions on possible changes to the current audit reporting model

Audits are normally performed using a risk-based approach as audits are intended to provide "reasonable assurance" and not "absolute assurance". Under a risk-based approach auditors obtain an understanding of the entity and its control environment, identify and assess the risks of material misstatements and determine the nature, extent and timing of their detailed tests. The auditor's report is the main, and in some cases the sole form of communication between the auditors and users of financial statements.

We agree with the IAASB's view that the expectation gap which currently exits is partly due to the fact that the standard unqualified auditor's report is boilerplate and generic. We believe that users wish to know more about the procedures performed by the auditor in forming his audit opinion, that is, "entity-specific" information.

Accordingly, we believe the IAASB should consider the following suggestions to enhance the value and relevance of audit reports, and to reduce users' misperceptions and concerns on what an audit involves:-

(a) *Level of assurance and materiality*

An auditor conducting an audit in accordance with ISAs is required to obtain "reasonable assurance" that the financial statements are free from "material" misstatement, whether due to fraud or error.

We believe that users do not fully understand the technical terms used in current audit reports such as "reasonable assurance" and "material misstatement". Moreover, current audit reports lack transparency and do not indicate clearly the level of assurance provided.

As set out in our letter to the Institute dated 29 July 2011 on "*ISAE 3000 (Revised) - Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*" we believe that the level of assurance provided by the auditor is linked to the concept of materiality. For example, if an auditor adopts 5% as a threshold of materiality for detecting misstatements, it would appear that the level of assurance of 95% is provided by the audit of the financial statements. However the level of assurance is not currently disclosed in audit reports and we would recommend that it become a requirement.

(b) *Summary of work performed on significant balances and transactions*

We believe that a summary of the work performed on significant account balances and transactions by the auditor will provide readers of the audit report a better understanding of how the auditor conducted his audit to arrive at his opinion on the financial statements. We believe the disclosure should include a concise high level summary of the nature, timing and extent of audit procedures performed. This information would help users better understand the work done by the auditor and whether the work meets his expectations and provides the appropriate level of comfort on the financial information. We believe that requiring the disclosure of a summary of work done would be a useful enhancement to audit reports and we note that the IAASB, in its exposure draft on proposed *ISAE 3000 (Revised)* - "*Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*", is also proposing that ISAE 3000 assurance reports include a summary of work done. We believe the disclosures will assist in reducing any misunderstanding or misperception on the nature and extent of work undertaken by an auditor and may also assist it explaining the level of audit fees charged and whether an adjustment is warranted.

(c) *Internal control system over financial reporting*

The reliability of financial statements is dependent on the effectiveness of the internal control systems that an entity has put in place. The current standard audit report states that "*the auditor <u>considers</u> internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, <u>but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control</u>*".

Except for companies that have very few transactions, we believe that in practice there is a need for auditors to place a degree of reliance on internal controls for at least some aspects of their audit. Although we note that auditors are not currently required to express an opinion on the effectiveness of internal controls, as suggested in paragraph (b) above, we believe that the audit report should at least include a summary of the audit work done and this should include an indication of the areas where internal controls were tested and regarded as sufficiently reliable to enable the auditor to rely on the controls and thus reduce the level of substantive tests that would normally have to be performed if the controls were absent.

(d) *Discussion on management letter and other forms of communication to the audit committee and those charged with responsibility for governance of an entity*

We suggest that auditors should be required to disclose in their audit report any significant matters in their management letters, if any, sent to entity. We believe that knowledge of such matters would be valuable to the shareholders' assessment of management's stewardship role and in particular any significant risks which affected the company's operations and the reliability of financial information produced by the entity. Although this disclosure may be regarded by some parties as having negative impact on the relationship between management and the auditor, we believe the greater transparency will be healthy. It will show more visibly the value added by the audit and that the auditors are independent of the entity and its management.

(e) *Assurance on other information disclosed outside the financial statements*

Currently, an auditor is not required to provide assurance on information that may be disclosed outside the financial statements, such as the MD&A and key performance indicators. The MD&A is an important narrative which should provide an unbiased analysis of the information provided in the financial statements as the financial statements alone are inadequate to provide users with a clear understanding of the performance and financial position of the entity to enable them to make better informed investment decisions. We believe that the historical information aspects of the MD&A, that is, sections of the MD&A excluding management's views about future prospects of the entity on which the auditor will not be able to audit, should form an integral part of the financial statements and therefore be covered by the audit report. This should ensure that the MD&A is balanced and provides a reasonable explanation of the significant events and transactions reflected in the financial statements.

(f) *Form and content of the audit report*

To implement our suggestions discussed above, we believe that long-form audit reports will be necessary. If the suggestions are adopted, the IAASB may wish to consider adopting the following suggested outline structure for the content of future audit reports:-

(i) Executive summary
(ii) Auditor's opinion on financial statements
(iii) Auditor's opinion on other legal and regulatory requirements, where applicable.
(iv) Level of assurance, expressed as a percentage, provided on the financial statements including materiality levels adopted in the audit of the entity as a whole and, where different, materiality levels adopted for major account balances and transactions.
(v) Summary of the work performed on material account balances and transactions. This should be in a tabular format showing in bullet point form the nature, extent and timing of work together with comments on the testing of internal controls where they have been relied on to reduce substantive tests.
(vi) Discussion on significant matters communicated to those charged with governance of the entity together with any action taken by management to date to address them.
(vii) Other matters which the auditors believe should be drawn to the attention of shareholders, which could include the respective roles and responsibilities of the directors and auditors.

We believe that the auditor's opinion should be placed immediately after the executive summary as this represents the ultimate conclusion from his work. The items (i) to (vii) would be useful enhancements to audit reports for listed entities but could be simplified for private companies where there is no separation of ownership and management.

We believe that the information suggested above should be available and already documented in the auditors' working papers and therefore should not require additional audit work to be done by the auditors. We would nevertheless accept that the audit report, being a long form report, will take more time to prepare especially in the first year of its adoption.

Auditors' liability

Any proposed changes to the auditor reporting model requires consideration of any implications on auditors' liability. Given the differences in national legal frameworks, the IAASB should ensure the legal aspects are also considered and are satisfactorily addressed.

Application to other assurance engagements

Finally, we believe that the above suggestions should not only be applicable to audits of annual financial statements, but could be considered for other "assurance" engagements such as reporting on investment circulars and listing documents. In this regard, we believe that there is a need for the IAASB to clearly define the meaning of an "assurance" engagement and set out the different types of assurance engagements that may be undertaken. We previously commented on this issue in our letter to the Institute dated 29 July 2011 on the IAASB's exposure draft on ISAE 3000 mentioned above.

We hope that the above comments are useful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited

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Senior Vice President
Listing Division

CC/ESA/el

c.c. Mr. Mark Dickens JP – Head of Listing