

IAASB Invitation to Comment

Improving Auditor Reporting

response to ITC

18 October 2012

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James Gunn
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Dear James Gunn

IAASB Invitation to Comment, Improving Auditor Reporting

CIPFA is pleased to present its response to this Invitation to Comment, which has been reviewed by CIPFA's Accounting and Auditing Standards Panel.

Comments

CIPFA welcomes this IAASB work in this difficult but important area, following on from the 2011 paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change*.

In CIPFA's response to the Options for Change paper we suggested that it would be worthwhile exploring development of reporting linked to governance frameworks. This would be in line with the UK FRC's consideration of reporting to, by and on audit committees in its January 2011 report *Effective Company Stewardship*.

We note that the current proposals focus wholly on the drafting of the standard audit report. While this approach might have advantages in being applicable to any jurisdiction regardless of the level of development of governance frameworks, we consider that there might still be advantages in allowing options based on reporting on communications with those charged with governance.

Going concern assessments in the public sector context

It may be that the Board is exploring the potential application of improved auditor reporting to the public sector based on a view that identifying going concern issues in public sector financial statements might provide early warning of potential shocks in the wider economy.

While we would agree with the desirability of high quality and effective audit and auditor reporting in the public sector, we believe that the going concern considerations in the preparation of many public sector financial statements are generally rather limited. In part this reflects the restricted nature of some public sector financial statements. We would also note that many lower tier public bodies are directly supported by government funding: in these cases, the going concern assessment equates directly to a view of the overall solvency and revenue generation capacity of higher levels of government, having regard to the totality of governments' commitments for all of their dependent entities. This in turn is dependent upon the overall financial health of the tax paying citizenry and the corporate sector. In practice the preparers of most public sector financial statements may not be carrying out any particularly sophisticated assessment of their financial position – their main concern will be whether the government plans to continue funding the entity.

Furthermore, many public sector financial statements provide little or no information on the financial position of the entity, and in many countries there are no financial statements which provide an indication of the overall financial position of the country. While economic statistical reporting is more generally carried out at national level, the reliability of these economic statistics may be questionable where there is no asset or liability information from financial reporting systems. From the point of view of improving matters in the light of the

economic crisis, we suggest that it would be more beneficial to prioritise improving public sector financial reporting rather than related auditor reporting. We accept that this is not an agenda which the IAASB is in a position to promote.

Applicability to public sector audits

As we explain in the attached Annex, we have reservations about the Board's proposals and concerns that these might make the report more difficult to read, which lead us to the view that these proposals should not generally be applied to public sector audits.

We understand that some stakeholders in private sector company reporting and particularly institutional investors might find this information helpful. Where this is the case, they might be prepared to undertake additional analysis and learning which might be required to benefit from and achieve a balanced assessment of the new information.

However, as the Board notes, the needs of users of public sector financial statements, and their access to the entity preparing the financial statements, will vary and may be different to those for listed entities. Public sector financial reporting is not principally carried out for the benefit of the institutional investor community, but for a much wider group of stakeholders including government and the wider public. We have significant concerns that it would not be realistic to expect members of the general public to make the additional effort required to read and understand the new form of report.

We would also note that in many jurisdictions the public sector auditors carry out additional assurance activities, or attach additional reporting to their 'financial' audit: these might serve to address similar issues to those which would be addressed by the IAASB proposals, or issues which are considered to be of comparable significance and relevance by local regulators or government. In addition, public sector activities will often be subject to additional inspection and checking by independent or quasi-independent bodies or functions other than the independent auditors of financial statements.

In the light of the above points, we suggest that the default expectation should be that auditors of public sector entities should not provide the additional auditor reporting set out in the current IAASB proposals.

The question of whether public sector entities should as a matter of course be considered as PIEs is less clear. The position in the United Kingdom is that most public sector entities are PIEs under the current definition, being required to undergo audit of comparable nature to listed companies, under similar independence requirements. There are however some very small entities whose financial statements are subject to independent assurance activities rather than full audit.

We agree that larger public sector entities should be subject to high quality audit, and we would normally see the cost benefit considerations as comparable to those for listed companies. As we explain in our answer to Question 18, we would not in any case see this as affecting the (non)applicability of the current proposals to public sector audits.

The paper explains that further dialogue with the International Organization of Supreme Audit Institutions (INTOSAI) on all the IAASB's suggested improvements and their applicability in the public sector is planned. While INTOSAI is the overarching body for Supreme Audit Institutions (SAIs), the Board might consider extending this dialogue to encompass Regional Audit Institutions (RAIs), for example through EURORAI, which acts as a representative body for RAIs in Europe through to Russia, and also has associate members from Brazil.

Other comments

Our responses to the specific questions are provided in the attached Annex.

I hope this is a helpful contribution to the development of the Board's guidance in this area. If you have any questions about this response, please contact Steven Cain (e:steven.cain@cipfa.org, t:+44(0)20 7543 5794).

Yours sincerely

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Responses to specific questions

Overall Considerations
1. Overall, do you believe the IAASB's suggested improvements sufficiently enhance the relevance and informational value of the auditor's report, in view of possible impediments (including costs)? Why or why not?
<p>No.</p> <p>While we understand the rationale for the proposals, as explained in our responses to subsequent questions, we are concerned that there would be adverse effects on the understandability and readability of the report, especially when viewed in the context of public sector financial reporting and the users of public sector financial statements.</p>
2. Are there other alternatives to improve the auditor's report, or auditor reporting more broadly, that should be further considered by the IAASB, either alone or in coordination with others? Please explain your answer.
<p>As noted in the CIPFA response to <i>Enhancing the Value of Auditor Reporting: Exploring Options for Change</i>, we consider that it would be worthwhile exploring development of reporting linked to governance frameworks, an approach which has been explored by the UK Financial Reporting Council.</p> <p>We recognise that this approach could only be applied where appropriate governance arrangements are in place, and would therefore need to operate within a flexible structure with alternative reporting options available where this was not the case.</p>
Auditor Commentary
3. Do you believe the concept of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report? Why or why not? (See paragraphs 35–64.)
<p>While we are sympathetic to the reasoning behind the development of Auditor Commentary, CIPFA does not consider that the proposals provide the desired improvement, having regard to the effect on understanding and readability of lengthening the report and including more detailed and specific content.</p> <p>Based on our reading of the Board's proposals we were also concerned that some stakeholder demands for additional information may reflect a view that auditors can fix problems in financial reporting. While we are keen that auditors should add value, we are sceptical of auditors providing a secondary layer of financial reporting. The Auditor's report should primarily focus on matters which relate to the audit. It should not be filling in gaps in financial statements, management</p>

commentary or other information, except to the extent already required to be reported on using emphases of matter or modified opinion. Providing disclosure which goes beyond this point blurs the distinction between the responsibilities of management and the responsibilities of the auditor.

Improving the reader's understanding of the general process of audit and the specifics of the particular engagement being reported upon is clearly a worthwhile aim. The challenge is to develop reporting which is understandable to non-auditors without overly increasing the length of the report or compromising its readability, and without other unintended consequences for the reporting process.

Against this background we can see that the Board has developed the concept of Auditor Commentary in a logical manner, and has sought to base reporting on work and thought processes which are already part of the audit process and potentially included in communications with Those Charged With Governance.

Having said this, notwithstanding the logic of the Board's approach, we did not find the material on Auditor Commentary to be successful in providing an understandable and useful public report for the non-specialist reader. We also consider that the additional material had the effect of making the other parts of the report less readable and less immediate.

4. Do you agree that the matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, with guidance in the standards to inform the auditor's judgment? Why or why not? If not, what do you believe should be done to further facilitate the auditor's decision-making process in selecting the matters to include in Auditor Commentary? (See paragraphs 43–50.)

As noted above, we have reservations about the usefulness of Auditor Commentary.

However, if the Board does proceed with this approach, we agree that the matters to be addressed should reflect the judgment of the auditor, and a natural starting point would be consideration of the matters communicated to Those Charged With Governance.

The need for clarity and brevity would need to be emphasised in any guidance provided.

5. Do the illustrative examples of Auditor Commentary have the informational or decision-making value users seek? Why or why not? If not, what aspects are not valuable, or what is missing? Specifically, what are your views about including a description of audit procedures and related results in Auditor Commentary? (See paragraphs 58–61.)

We did not find the examples helpful, and were also concerned that readers might draw incorrect conclusions from them.

The first three examples draw attention to disclosures already included in the financial statements, in line with the proposal to re-calibrate the threshold for inclusion of emphases of matter. The ITC explains at paragraph 42 the Board's view that Auditor Commentary is consistent with the existing concepts of EOM and Other Matters.

However, we see the proposed change as a significant transformation. The proposals may shift reporting from rare and infrequent disclosures of matters of fundamental importance to default reporting on matters whose importance should perhaps be obvious. A great deal of consideration was given to the focus of emphases of matter in successive ISA redrafting including as part of the Clarity Project. CIPFA's view remains that a principal benefit of EOMs is that they are exception reporting. In line with paragraph A2 of the extant ISA 706, widespread use of EOM paragraphs would diminish the effectiveness of the auditor's communication. The wider commentary on financial statements may also blur the distinction between the responsibilities of management and the auditor.

Commenting on the process and conduct of the audit is also difficult to do in other than general terms, and there is a risk that this part of Auditor Commentary might gravitate to matters that are sufficiently easy to explain. We note that the third example comments on the results of audit testing, but that the fourth example does not and that in practice it might be difficult to convey. Even without relating the results of the work, it may be interpreted as providing a specific assurance which does not reflect the nuanced risk assessment or other evaluation carried out. For more complex testing or testing which addresses risks in politically or commercially sensitive areas, or where there are concerns about the probity of management activities, we would see difficulties in saying anything very informative.

The fifth example might also be seen to undermine the principle of sole responsibility of the group auditor

Furthermore, we would note that in a public sector context, users of financial statements are primarily concerned with stewardship of public funds/assets, rather than "the bottom line". Whilst the significant risks may similarly be around significant accounting estimates etc, these users are probably less interested in information on how these were audited. They would be more interested in issues such as regularity and propriety. This is a further reason why the applicability of the proposals is questionable for the public sector, particularly if any elements of the auditor commentary were to be mandated in the ISAs.

6. What are the implications for the financial reporting process of including Auditor Commentary in the auditor's report, including implications for the roles of management and those charged with governance (TCWG), the timing of financial statements, and costs? (See paragraphs 38 and 62–64.)

As indicated in our responses to previous questions, we do not support the proposed approach. On the specific matter of Auditor Commentary we have concerns that including this material in the auditor's report would blur the distinction between the responsibilities of management and the responsibilities of the auditor.

We can see that some additional work might be required in agreeing the forms of report, that there might be timetabling issues, and that in some cases there might be other than small amounts of additional cost. However, our principal concern is not in respect of these matters.

7. Do you agree that providing Auditor Commentary for certain audits (e.g., audits of public interest entities (PIEs)), and leaving its inclusion to the discretion of the auditor for other audits is appropriate? Why or why not? If not, what other criteria might be used for determining the audits for which Auditor Commentary should be provided? (See paragraphs 51–56.)

Our general view of the proposals is that they will result in longer reporting, some of which relates to matters not previously included in reports, and which require a greater degree of effort and understanding of the audit process. There may also be additional costs.

We can see that the investor community and particularly institutional investors may be prepared to make the necessary efforts to read and understand the resulting longer and more comprehensive form of reporting, and if this is the sort of reporting they are looking for, we assume that they will be prepared to pay a reasonable additional cost.

We might expect users of financial statements who are not members of the investor community to be more comfortable with more concise reporting provided by the current model. We consider that it would be better for decisions on wider applicability to be made by local or national regulators rather than by the auditor, who already has the option to raise particularly significant issues through Emphases Of Matter and reporting on Other Matters.

In the public sector context there are other reporting mechanisms by which auditors can, and do report matters of interest to the public, negating the need for the auditor commentary in the public sector.

CIPFA would not support application of this approach to PIEs without further information on how this might benefit stakeholders in auditor reporting for all PIEs. As far as we are aware, most of the appetite for the additional reporting comes from institutional investors and analysts, and if the Board proceeds with further development of this approach it would seem sensible to focus on those areas where they have an ownership interest, particularly listed companies.

We would be concerned that applying the Board's current proposals for Auditor Commentary to PIEs might have the effect of equating the 'public interest' with the much more specific interest of institutional investors.

Going Concern/Other Information

8. What are your views on the value and impediments of the suggested auditor statements related to going concern, which address the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified? Do you believe these statements provide useful information and are appropriate? Why or why not? (See paragraphs 24–34.)

CIPFA does not support the inclusion of significant information on management's use of the going concern assumption.

Furthermore, in the public sector context the information is often not relevant, and when it is relevant it is more likely to warrant a full scale EOM or perhaps modification of the auditor's report.

Mandating early disclosure of this element of the audit report would be unhelpful for most public sector financial statements.

9. What are your views on the value and impediments of including additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statement that no material uncertainties have been identified? (See paragraphs 30–31.)

CIPFA supports the provision of brief information on the auditor's judgment relating to going concern issues relating to general purpose financial statements prepared under a fair presentation framework, but not the process undertaken by the auditor.

We would note that many public sector financial statements are prepared under special purpose frameworks and do not provide or provide only a limited view of the financial position of the entity.

10. What are your views on the value and impediments of the suggested auditor statement in relation to other information? (See paragraphs 65–71.)

CIPFA is content with the proposed statement in relation to other information.

Clarifications and Transparency

11. Do you believe the enhanced descriptions of the responsibilities of management, TCWG, and the auditor in the illustrative auditor's report are helpful to users' understanding of the nature and scope of an audit? Why or why not? Do you have suggestions for other improvements to the description of the auditor's responsibilities? (See paragraphs 81–86.)

CIPFA does not consider these to add sufficient value to be helpful.

We found the expanded descriptions of management responsibilities of particularly limited value.

12. What are your views on the value and impediments of disclosing the name of the engagement partner? (See paragraphs 72–73.)

This is standard practice in many jurisdictions and we do not see a problem with this disclosure, subject to appropriate exemptions in specified circumstances: for example where the auditor or persons associated with the auditor might be at risk of intimidation or violence.

13. What are your views on the value and impediments of the suggested disclosure regarding the involvement of other auditors? Do you believe that such a disclosure should be included in all relevant circumstances, or left to the auditor's judgment as part of Auditor Commentary? (See paragraphs 77–80.)

During the development of the clarified ISA 600 on group audits CIPFA supported the requirement for the group auditor taking sole rather than divided responsibility. We would not support disclosures which have the effect or appearance of diluting sole responsibility.

14. What are your views on explicitly allowing the standardized material describing the auditor's responsibilities to be relocated to a website of the appropriate authority, or to an appendix to the auditor's report? (See paragraphs 83–84.)

We would support moving generic additional material on responsibilities out of the main report. This approach is used for the audits of private sector entities in the UK. However, given that the users of public sector financial statements potentially include all citizens, this approach is not used. Certainly for public sector entities it is helpful that a base level of description of responsibilities is retained in the report so that it remains readable.

Form and Structure

15. What are your views on whether the IAASB's suggested structure of the illustrative report, including placement of the auditor's opinion and the Auditor Commentary section towards the beginning of the report, gives appropriate emphasis to matters of most importance to users? (See paragraphs 17–20.)

As noted above, CIPFA does not support the Auditor Commentary and does not support the inclusion of all of the additional reporting. However, for those audits where this reporting is required, the suggested structure does have the effect of emphasising certain matters, the importance which might otherwise be lost on readers because of the distracting effect of the additional information.

In the public sector context we would have particular concerns about other reporting requirements being at the end of the report. Some of these such as the regularity opinion are of equal importance to the opinion on financial statements and others are integrally linked to the opinion on financial statements. It would not be helpful to have these at the end of the report.

16. What are your views regarding the need for global consistency in auditors' reports when ISAs, or national auditing standards that incorporate or are otherwise based on ISAs, are used? (See paragraphs 21–23 and 87–90.)

While we can see that uniform reporting styles would provide more apparent global consistency, we would be wary of promoting this type of consistency too far.

We are particularly concerned that uniform styles of reporting would not be in the interests of all users of financial statements and might result in missing opportunities for other reporting and processes based upon governance frameworks where these exist.

We separately address the question of consistency across economic sectors in our answer to question 18.

17. What are your views as to whether the IAASB should mandate the ordering of items in a manner similar to that shown in the illustrative report, unless law or regulation require otherwise? Would this provide sufficient flexibility to accommodate national reporting requirements or practices? (See paragraph 17 and Appendix 4.)

We have noted our concerns over the additional reporting including Auditor Commentary. However, in line with our comments at 15, we would expect the Board to encourage the proposed ordering for any audits which it deems that the additional reporting is required.

In cases where auditor reporting is more concise, the ordering is less critical, and in some ways the current order might be considered to have some advantages in terms of setting the scene for the auditor's opinion.

18. In your view, are the IAASB's suggested improvements appropriate for entities of all sizes and in both the public and private sectors? What considerations specific to audits of small- and medium-sized entities (SMEs) and public sector entities should the IAASB further take into account in approaching its standard-setting proposals? (See paragraphs 91–95.)

In line with our comments in the covering letter and in response to other questions, we do not support the application of the IAASB's suggestions to the public sector as a matter of course. We would not see this as being in the interests of the majority of users of the financial statements, and we are not aware of any significant degree of stakeholder demand for this information. We suggest that public sector entities should be scoped out of the proposals, perhaps by focussing the proposals on listed entities. If public sector entities are scoped in by focussing on Public Interest Entities, then we suggest that at the very least the requirement for Auditor Commentary should be withdrawn by virtue of reflecting the different position of the users of public sector financial statements.