***Auditing Standards Committee***
***Auditing Section – American Accounting Association***

March 14, 2013

Via IAASB website

**RE:** Invitation to comment on ISA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on your recent Invitation to Comment on your proposal entitled *ISA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon.*

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Contributors:


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***Responses to Specific Questions in the Invitation to Comment***

1. ***Do respondents agree that there is a need to strengthen the auditor's responsibilities with respect to other information? In particular do respondents believe that extending the auditor's responsibilities with respect to the other information reflects costs and benefits appropriately and is in the public interest?***

   We agree. There is clearly a need for additional information issued by corporations in their financial reports to be examined by auditors in some form or manner. Today audited financial statements represent only a sub-section of the typical annual report, and it is not clear whether such audited financial statements represent incrementally new information. In light of the fact that the bulk of market reaction to financial statement information release occurs at the date of the release of unaudited press release, it is unclear whether annual reports themselves convey material value relevant information (Hollie, Livnat, Segal, 2011). So, other information released in the annual report is likely to matter to the extent that it is not stale, and to the extent that it is consistent or inconsistent with the audited financial information. For example, Brazel, Jones and Zimbelman (2009) show that when unaudited non-financial measures are inconsistent with financial statement information, risk of fraud is higher. So, this suggests that auditors should pay attention to the information in annual report or in other types of regulatory filings that could be inconsistent with the audited numbers. For instance, inclusion of aggressive pro-forma numbers in regulatory filings could also be misleading to investors, and this suggests that auditors should watch over such aggressive practices.[1] However, the extent of the auditor responsibility for review of this additional information as well as the reporting language need to be clearly defined. In the absence of such clarity, this ISA could add to the responsibilities of auditors without reducing their exposure to added legal liabilities.

   In light of the latter, one contributor also has concerns about whether the proposed standard truly provides benefits that advance the public interest, and the potential costs imposed on the auditor. Our concerns are based on the fact that the standard potentially requires the auditor to either withdraw from the engagement or address material inconsistencies in the absence of procedures that amount to those required by an audit, or even a review. Hence, the standard ought to carefully define *the scope and timing* of the auditor's responsibility to review other such unaudited information. Absent such clear definition, auditors remain even more exposed to potential litigation which could have undesirable consequences for the audit markets.

   In addition, we are concerned that the exposure draft asks auditors to state whether the other information is consistent with the audited financial statements, which seems reasonable. Para. 16(d) indicates that the auditor is to state in the audit report that she/he "has not audited or reviewed the other information and accordingly does not express an audit opinion or a review conclusion on it". If the other information is neither audited nor reviewed, how much value can financial statement users and the general public place on the auditor's views on the other information? Furthermore, the proposed standard calls

[1] A good case in point is aggressive disclosure by Groupon (http://money.cnn.com/2011/08/10/technology/groupon_accounting/index.htm). There is some evidence that auditors may already pay attention to such aggressive disclosures (see, for example, Chen, Krishnan, Pevzner, 2012 and Krishnan, Pevzner, Sengupta, 2012).

for the auditor to consider withdrawing from the engagement "when the [materially inconsistent] other information was obtained prior to the date of the auditor's report" [Para. 14(a)(ii)] and "is not corrected after communicating with those charged with governance" (Para. 14).

Therefore, the proposal potentially places the auditor in the position of withdrawing from an engagement before issuing the audit report, even if the timing of receipt of the other information is after the fiscal year end but before the audit report date, based on procedures that do not amount to an audit or review and do not actually affect the audit opinion (Para. 16 requires the auditor to note any identified material inconsistencies in the audit report, but there is no impact on the audit opinion itself). Is it practical for an auditor to consider withdrawing from a financial statement audit over a reporting issue that does not affect the financial statement opinion?

Furthermore, one contributor is concerned with the extent of the true benefit to the public interest from adding an explanatory statement or paragraph to the audit report based on inconsistent nonfinancial information when the independent accountant has not audited or reviewed the other information. An audit is valuable because of its nature. The public and capital markets rely on audited financial statement because an audit opinion represents the results of a detailed examination of financial statement assertions. When non-audited information is not subjected to the same level of examination of evidence as regular audit, it is unclear how valuable will be auditors' reference to such information to the report. While it could be argued that highlighting the importance of this information by making a reference to it could serve public interest, it could also confuse users of the financial reports. After all, annual reports are already rather long and at times hard to read, and having an auditor make an unclear reference to something that was not audited could confuse financial statement users even more. Thus, it is important to ensure that any additional information the auditor is to review or examine has been meaningfully opined on. Absent such clear opinion, the users may ignore auditor statements about such disclosures, or, worse yet, use this lack of clarity to sue auditors.

In addition, since this is proposed international auditing standard, it is important to think about the general interaction of legal regimes in different countries and auditor responsibility for additional disclosures. For example, in the US, auditors are only responsible for the actually audited financial statements, and we are not aware of any court cases where auditors were sued successfully over misleading voluntary disclosure. What about the implications of security laws in other countries when it comes to auditors? Could there be a situation whereby the lack of clarity with respect to auditor responsibility for additional information beyond required financial statement disclosures under this ISA would actually increase auditor legal liability?

3. ***Do respondents find the concept of initial release clear and understandable? In particular, is it clear that initial release may be different from the date the financial statements are issued as defined in ISA 560?***

   One concern is that client managers may simply delay the release of other information to avoid an explanatory statement in the audit report. Para. 16 only applies if the auditor received the other information before the date of the audit report. If a client delays disclosing materially inconsistent other information to the auditor until after the audit report date but before filing the financial statements with the appropriate regulatory body, what action(s) should the auditor consider (e.g., a dual dated audit report)? In addition, it is not clear why an early release of other information to third parties, such as a bank, not considered initial release? Any inconsistency or misstatement may adversely affect the bank (see Para A4 and footnote 2). Auditors could be sued by the bank.

   Also, as noted in A5 ISA 560, "In the case of the public sector, the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public." It is unclear whether "Publishing the documents in accordance with law or regulation" in A4 of ISA 720 belongs to either of the above cases. The phrase "the group of users for whom the auditor's report is prepared, often the shareholders" in paragraph 9(b) seems vague.

4. ***Do respondents agree that the limited circumstances in which a securities offering document would be in scope (e.g., initial release of the audited financial statements in an initial public offering) are appropriate or should securities offering documents simply be scoped out? If other information in a securities offering document is scoped into the requirements of the proposed ISA in these circumstances, would this be duplicating or conflicting with procedures the auditor may otherwise be required to perform pursuant to national requirements?***

   Audited financial statements constitute core documents in securities filings. As such any component of the securities offering documents that are "in connection" with the audited financial statements should be in scope. To selectively leave some documents out of scope will expose auditors to excess legal liability. Recent example of inclusion by Groupon of aggressive pro-forma metric into a form S-1 is something that auditors should be concerned with.

5. ***Do respondents consider that the objectives of the proposed ISA are appropriate and clear? In particular:***
   ***(a) Do respondents believe that the phrase "in light of the auditor's understanding of the entity and its environment acquired during the audit" is understandable for the auditor? In particular, do the requirements and guidance in the proposed ISA help the auditor to understand what it means to read and consider in light of the auditor's understanding of the entity and its environment acquired during the course of the audit?***

***(b) Do respondents believe it is clear that the auditor's responsibilities include reading and considering the other information for consistency with the audited financial statements?***

The proposed ISA provides helpful detailed guidance on how "read and consider the other information" in A28 through A43. Paragraph 8 of the proposed ISA makes it clear that the auditor's responsibilities include reading and considering the other information for consistency with the audited financial statements.

At the same time, as we discuss above, the use of the terms "read and consider" is open to varying interpretations. That leaves the responsibility of the auditor unclear and, in turn, fails to protect the auditor from class action lawsuits. The added benefits of clarity of the language outweigh the burden of added responsibility.

***6. Do respondents agree that the definitions of terms of "inconsistency" including the concept of omissions and "a material inconsistency in the other information are appropriate?***

It is appropriate for the proposed ISA to include the concept of omissions and "a material inconsistency in the other information" in the definitions of terms of "inconsistency." Omitting information that is expected to influence the economic decisions of the users for whom the auditor's report is prepared can potentially mislead the users. Thus, it is beneficial to include both concepts in the definition of "inconsistency." In addition, the clarification about "material inconsistency" helps to set a reasonable boundary for auditors to decide the scope of their reports.

***7. Do respondents believe that users of auditors' reports will understand that an inconsistency relates to an inaccuracy in the other information as described in (a) and (b) of the definition, based on reading and considering the other information in light of the auditor's understanding of the entity and its environment acquired during the course of the audit?***

Users of auditors' reports should be able to understand that an inconsistency relates to an inaccuracy in the other information as described in paragraph 9(a) (i) and 9(a)(ii) of the definition, based on reading and considering the other information. The phrase "in light of the auditor's understanding of the entity and its environment acquired during the course of the audit" seems unnecessary because the phrase reflects a general assumption regarding the basis of auditors' reports.

The language of auditor's report should be sufficiently clear to the users to convey the information about inaccuracy or inconsistency. However, we are concerned that, given lack of clear definition of the level of evidence needed to be gathered by the auditor to note an inconsistency, the auditor may not be able to be sufficiently clear about presence of such inconsistencies.

9. ***Do respondents believe that the examples of qualitative and quantitative information included in the Appendix in the proposed ISA are helpful?***

   The examples of qualitative and quantitative information included in the Appendix in the proposed ISA are helpful. Additionally, because qualitative and quantitative information are related to financial information, it is perhaps better to list “Quantitative or qualitative” after “Financial or non-financial” in A42 of this proposed ISA.

10. ***Do respondents believe it is clear in the proposed requirements what the auditor’s response should be if the auditor discovers that the auditor’s prior understanding of the entity and its environment acquired during the audit was incorrect or incomplete?***
    The proposed requirements clearly specify what the auditor’s response should be if the auditor discovers that the auditor’s prior understanding of the entity and its environment was incorrect or incomplete. To make the requirements more clear, it is perhaps better to add “ISA 315 paragraph 31 addresses the responsibility of the auditor in such circumstances” at the end of A49 of this proposed ISA rather than using the footnote #16.

11. ***With respect to reporting:***
    ***(a) Do respondents believe that the terminology (in particular, “read and consider,” “in light of our understanding of the entity and its environment acquired during our audit,” and “material inconsistencies”) used in the statement to be included in the auditor’s report under the proposed ISA is clear and understandable for users of the auditor’s report?***

    See our response to question 5 above. The use of the term “read and consider” does not lessen the extent of auditor liability to users or audited statements. Either users or management may bring a lawsuit against auditors for damages caused by lack of sufficient “consideration” or for language in the final report that may cast doubt on the credibility of annual report or similar other information.

    ***(b) Do respondents believe it is clear that the conclusion that states “no audit opinion or review conclusion” properly conveys that there is no assurance being expressed with respect to the other information?***

    If this ISA eventually settles on auditor responsibilities that are less than conducting full review or audit procedures, then the proposed reporting language is correct. However, once a professional standard requires the auditor to “read and consider other information”, such disclaimer may not have much weight if challenged by users or by management.

***Other***

We also recommend consideration of a new paragraph in the Documentation section of the proposed standard to require the auditor to document all discussions with management required by the proposed standard (e.g., the discussions required in Paragraphs 10 and 13). While Para. 20 refers to documenting the work required by this standard, we think it is best to err on the side of caution to provide assurance that auditors will document their discussions with client management and "those charged with governance" (Para. 14). Another option is to add clarification to Para. 20 to include these discussions.

**References:**

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Holie, D., J. Livnat, and B. Segal (2011). Earnings Revisions in SEC Filings From Prior Preliminary Announcements. *Journal of Accounting, Auditing, and Finance*, 27(1), 3-31

Chen, L., Krishnan, G., and Pevzner, M. (2012). Pro-Forma Disclosures, Audit Fees, and Auditor Resignations, *Journal of Accounting and Public Policy*, 31(3), 237-257 (lead article).

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