

Onderwerp: Response to request for comments in IAASB Consultation Paper

Dear Arnold,

I am writing in response to the request for comments in the recent IAASB Consultation Paper on "Enhancing the Value of Auditor Reporting: Exploring Options for Change". While my comments are not being submitted through the IAASB website, I hope you will pass them on to the IAASB Technical Director and will feel free to treat them as a matter of public record to ultimately be posted on that website.

As I previously told you, I found the Consultation Paper to be an extremely well written, thorough and thoughtful discussion of the options for change to the current auditor reporting model. The entire Board and its staff should be commended for having taken the lead and seized the high ground on an issue of growing interest and importance to users of financial statements and auditors' reports.

As you know, I have published a number of articles over the years on the role of auditors and others in the financial reporting supply chain as well as on the usefulness and relevance of the current auditors' report. The very first -- "The Auditor's Role in Society: A New Approach to Solving the Perception Gap" -- was included in the February 1986 issue of the 'Journal of Accountancy' over 25 years ago.

In that article, I pointed out "(t)here are two obvious ways to narrow the gap between the profession's understanding of its audit responsibilities and users' expectations. One, of course, is to better educate the public as to the role and limitations of the audit. The other -- which, admittedly, the profession has been slow to acknowledge -- is to recognize that the profession might well be able to extend the auditor's current role to satisfy the legitimate needs of users...."

In that light, I went on to recommend for starters moving management's discussion and analysis (M,D&A) of financial condition and results of operations into the financial statements or otherwise making it subject to audit. In my view, the requirement in M,D&A to "focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition" is the kind of early warning system that users of financial statements are increasingly looking for.

In this respect, as I noted in a subsequent article, "people are increasingly looking to sources other than financial statements for useful information" because, among other things, "financial statements offer only limited, spotty disclosures of risks and uncertainties or the factors on which the company's future success most depends." I went on to say "I believe investors and others want and expect more: more predictive and value-based information; more of the whys -- not simply whats -- of financial data; and more of an early warning that a company is making poor decisions or may be nearing the brink of financial collapse."

Unfortunately, while moving the M,D&A into the audited financial statements or otherwise subjecting it to audit would have been a highly positive step in that direction, I was never able to convince the then Chief Accountant of the US SEC or others to adopt this recommendation. However, 25 years later, I still believe it would be the best and easiest way -- with a long standing requirement for such management commentary in the US and elsewhere and even a US attestation standard covering the process for providing assurance on M,D&A -- to accommodate users growing desire for more useful information from the audit.

Although some have recently suggested the issuance of a separate "Auditors Discussion and Analysis", I am firmly of the view that it is important to clearly differentiate the role of the company as the provider of information and of the auditors as the group that provides assurance on such information. That is not to say that auditors do not significantly influence the information being presented. For instance, every time an auditor suggests a modification to financial statements and related footnotes he/she is indirectly affecting the information provided.

Moreover, I firmly believe that if the M,D&A were required to be audited the quality of the disclosures made in this important "management commentary" would improve. Furthermore, in addition to subjecting it to audit, I would suggest a revisiting of the current requirements for M,D&A and similar management/directors reports in other countries to encourage more in-depth commentary on management's plans and strategies; major risks, uncertainties and opportunities; the competitive environment; and nonfinancial performance indicators but that is likely to be very controversial and goes beyond the subject of your current consultation.

There is, of course, a lot of other useful information that an auditor gains in connection with the performance of the audit. In this respect, I stated years ago that we need to "ensure that clients and the public obtain the full benefit of the information gathering, analyzing and evaluating skills of CPAs in performing the traditional audit function....Financial statements may be static, but the business problems an auditor must assess in examining them are not. Failure to provide a critical financial analysis and recommendations could be justly criticized as contrary to the public interest."

On the other hand, I would only require these disclosures be made to management and the Audit Committee and Board of Directors which are the elected representatives of the shareholders. With the passage of the Sarbanes-Oxley Act and the significant beefing up in recent years of the corporate governance responsibilities of independent directors in the US and elsewhere, and with their clear fiduciary duty to the shareholders, this would seem to be the most logical place for such disclosures.

Moreover, I would include in the required disclosures the auditor's assessment of the accounting standards adopted by the company and the level of conservatism in management decisions such as the amount of required reserves. Hopefully, like the significant influence auditors can have on actual financial statement disclosures, they will similarly influence the board's position on the accounting standards ultimately adopted and judgments ultimately made by management.

With respect to the position by some that there needs to be a better/expanded description of the audit process, I would again go back to a recommendation contained in my 1986 'Journal of Accountancy' article for better educating the public as to the role and limitations of the audit. Specifically, I suggested the inclusion of a supplementary Explanation of the Audit and Auditor's Report in published annual reports and actually included an example in that article.

I recommended this alternative to modifying the traditional report language because, at that time, the standard auditor's report had been in constant use for almost 40 years and "may have become so entrenched in the profession and business community that any new movement to change it would...become ensnarled in an endless debate over words, phrases, nuances, interpretations and implications."

Of course, the standard report has since been modified and some of the basic concepts I suggested be included in an alternative supplementary Explanation have been incorporated into the current report language. However, I still feel that changing the actual auditors report could be more difficult than adding a supplementary explanation and do not think the report language should in general be changed very often. Moreover, I would be strongly opposed to simply making smaller cosmetic changes.

I hope these comments and observations are helpful to the IAASB as you move on to the next phase of this very important project. As I pointed out back in 1986, "It is my strong belief that the profession must be open to the idea of expanding the auditor's role if it doesn't want to find itself in a position of declining importance to the future of the US (now global) capital markets." While 25 years have passed since then, I firmly believe that the need for fundamental change is now quite clear to substantially all and, once again, commend the Board for taking the lead on this initiative.

If you have any questions or desire any clarification on any of the comments and suggestions contained in this letter, please don't hesitate to give me a call.

Sincerely,

Robert Mednick