

THE  
INSTITUTE OF  
CHARTERED  
ACCOUNTANTS  
OF SCOTLAND



Response from The Institute of Chartered Accountants of  
Scotland to the International Auditing and Assurance  
Standards Board

Enhancing the Value of Auditor Reporting:  
Exploring Options for Change

**21 October 2011**

## INTRODUCTION

The Institute's Audit and Assurance Committee has considered the Consultation Paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change* and is pleased to forward its comments to the International Auditing and Assurance Standards Board (IAASB).

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires the Audit and Assurance Committee to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

## KEY ISSUES

### ICAS Future of Assurance Working Group

We would draw your attention to the above report published by an ICAS Working Group in December of 2010. This can be downloaded at: [www.icas.org.uk/futureofassurance](http://www.icas.org.uk/futureofassurance). This Working Group was established to consider some of the issues which had been raised in relation to the role of auditors and the assurance they provide on corporate information following the financial crisis. It also considered specifically whether any additional reporting requirements should be the responsibility of the audit committee (those charged with governance) or the auditor. The recommendations of the Working Group which we believe are relevant to the IAASB in its deliberations are presented below.

### The Audit Committee Report:

- An expanded and more transparent audit committee report is required and should include:
  - A matrix-style report which maps the key risks disclosed by the Board in its report to the assurance processes used to gain assurance over those risks. A substantive discussion of how the audit committee satisfied itself of the appropriateness of management's judgements.
  - Details of the key areas discussed between the audit committee and the auditors, including the main areas of audit challenge.
  - The date the audit firm was first appointed and the date the appointment was last subjected to a full tendering process.
  - The policy of the audit committee in relation to how often it expects to tender the audit appointment.
  - In addition to the current annual review of effectiveness of the audit process, every five years the audit committee should undertake a more in depth review of the audit appointment and should engage with shareholders through this process – the report should reflect this review process and its conclusions.
  - The reasons behind any decision to re-tender the audit appointment (other than simply compliance with their own policy) and the circumstances of any resignation or dismissal of the auditor.

### **The External Audit Report:**

A qualified audit opinion is a rare occurrence in the UK and in many other jurisdictions – and the rarity of the qualification gives it power. A qualified external audit report sends an adverse signal to the market. The Board will want to avoid that qualification – which puts the external auditor in a strong position to persuade the Board to “get it right”. The rarity of audit qualifications suggests that Boards and external auditors normally reach a conclusion acceptable to both parties. An emphasis of matter is not a qualification but draws the user’s attention to a matter of fundamental importance – for example where the going concern status of the company is subject to doubt. We believe that the current use of these qualifications and emphases of matter is appropriate.

We accept that users want to understand more about the external audit process but a longer form audit report can confuse who is speaking to the user: is it the company or the auditor? We believe that an improved understanding of the audit process should be achieved through the enhanced audit committee report discussed above, without diluting the power of the audit qualification. In responding to the concerns of the users of the audit report, it is vital to make a clear distinction between the responsibilities of management versus those of the auditor. The responsibility for the production of the annual report and the financial statements and the accuracy of that document is that of management. The responsibility of the auditor is then to provide an opinion on the truth and fairness of the document. The auditor should not be a substitute for management.

We do however believe that there is more work that the auditor should be required to do and that the following additional matters should be included in the audit report.

- The auditor should include an explicit opinion on whether the going concern assessment conducted by management is reasonable (simply articulating the work the auditor is already required to perform under the International Standards on Auditing).
- The auditor should include an opinion on whether the annual report (excluding the financial statements) is “balanced and reasonable”. A framework needs to be developed to support such an opinion but we do not envisage an “audit” of the narrative. This opinion should be delivered using the auditor’s existing knowledge and understanding of the business with some additional work where necessary.
- The auditor should include an explicit reference to the audit committee report and its disclosure of the key areas discussed between the auditors and the audit committee.

### **Summary of ICAS Position**

- We do not believe there is a need to fundamentally change the format of the existing auditor’s report on financial statements, although we would support any simplification that makes it easier for users to understand its content, including the removal of technical jargon.
- We do however believe that additional reporting should be provided but that, in the first instance, this should be the responsibility of the audit committee (those charged with governance) of the audited entity.
- The additional reporting requirements that we would wish to see introduced are detailed above.

Our responses to the specific questions posed in the consultation paper are set out below.

*1. Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?*

We support the viewpoint that there is a need for greater transparency about the matters discussed in paragraph 22 of the consultation paper i.e. key financial reporting risks and key areas of audit risk. However, we believe that such matters should be conveyed via a report from the audit committee (those charged with governance of the entity) rather than via the report from the external auditor. The entity should be the original source of disclosure of information of this nature. The auditor should of course, in our view, be asked to review the information provided by those charged with governance.

*2. If respondents believe changes in auditor reporting are needed, what are the most critical issues to be addressed to narrow the information gap perceived by users or to improve the communicative value of auditor reporting? Which classes of users are, in the view of respondents, most affected by these issues? Are there any classes of users that respondents believe are unaffected by these issues?*

As per our response to question 1 above, we believe that the first step to close the so called information gap is for the audit committee (those charged with governance) to provide more informative and better quality reports. We believe this should include:

- a matrix-style report which maps the key risks disclosed by the Board in its report to the assurance processes used to gain assurance over those risks;
- a substantive discussion of how the audit committee satisfied itself of the appropriateness of management's judgements; and
- details of the key areas discussed between the audit committee and the auditors, including the main areas of audit challenge should also form part of this report.

Secondly, we believe that the following additional reporting is required from the external auditor:

- an explicit opinion on whether the going concern assessment conducted by management is reasonable (simply articulating the work the auditor is already required to perform under the International Standards on Auditing);
- an opinion on whether the annual report (excluding the financial statements) is "balanced and reasonable". A framework needs to be developed to support such an opinion but we do not envisage an "audit" of the narrative. This opinion should be delivered using the auditor's existing knowledge and understanding of the business with some additional work where necessary; and
- the auditor's report should also include an explicit reference to the audit committee report and its disclosure of the key areas discussed between the auditors and the audit committee.

We do not see any need to change the fundamental pass or fail nature of the audit report on financial statements.

*3. Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities?*

We believe that an audit is an audit and that the basic structure of the audit report of all entities should be the same. However, there are already differences in the audit reports issued to certain classes of entity e.g. listed entities where additional reporting requirements already apply. The changes that we have proposed above were designed with listed entities specifically in mind. However, other entities may wish to take on board any such developments and should not be prohibited from doing so.

*4. Respondents are asked for their reactions to the options for change regarding the format and structure of the standard auditor's report described in Part A. Do respondents have comments about how the options might be reflected in the standard auditor's report in the way outlined in Appendix 1 of this Consultation Paper?*

We believe that there is scope for reducing the length of the audit report by removing some of the standardised text from such reports and replacing this with a link (see response to question 5 below) to an appropriate website where a user could view the detail, if required.

*5. If the paragraphs in the current standard auditor's report dealing with management and the auditor's responsibilities were removed or re-positioned, might that have the unintended consequence of widening the expectations gap? Do respondents have a view regarding whether the content of these paragraphs should be expanded?*

We do not believe that either course of action would result in widening the expectations gap. The Auditing Practices Board in the UK currently allows the choice of including a brief description of the auditor's responsibilities in the audit report or including a cross reference to where a more detailed description can be found. In the UK for example the description can be found on the APB's website.

*6. Respondents are asked for their reactions to the possibility that the standard auditor's report could include a statement about the auditor's responsibilities regarding other information in documents containing audited financial statements. Do respondents believe that such a change would be of benefit to users?*

The Auditor's responsibility in relation to other information in documents containing audited financial statements should be clear. This could either be briefly described in the audit report or cross referenced via a weblink to a statement which provides clarity on the responsibilities of the auditor.

*7. If yes, what form should that statement take? Is it sufficient for the auditor to describe the auditor's responsibilities for other information in documents containing audited financial statements? Should there be an explicit statement as to whether the auditor has anything to report with respect to the other information?*

As stated at 6 above, this could either be briefly described in the audit report or cross referenced via a weblink to a statement which provides more detail on the responsibilities of the auditor. Reporting in this context would preferably be by exception.

*8. Respondents are asked for their views regarding the auditor providing additional information about the audit in the auditor's report on the financial statements.*

As noted in our key points we firmly subscribe to the viewpoint that additional information in relation to the audit should be provided by the audited entity (audit committee) in the first instance. This should be the first step in seeking to remove the information gap which is said to exist.

*9. Respondents are asked for their reactions to the example of use of justification of assessment in France, as a way to provide additional auditor commentary.*

We are not supportive of this approach. As we have stated above, we believe that in the first instance additional information in relation to the audit should be provided by the audit committee (those charged with governance) and not the auditor.

*10. Respondents are asked for their reactions to the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor's report.*

We are not supportive of this approach. As we have stated above we believe that in the first instance additional information should be provided by the audit committee (those charged with governance) of the entity and not the auditor. We do believe however that there would be merit in the auditor providing assurance on whether the annual report (excluding the financial statements) is "balanced and reasonable". A framework needs to be developed to support such an opinion but we do not envisage an "audit" of the narrative. This opinion should be delivered using the auditor's existing knowledge and understanding of the business with some additional work where necessary. We believe that such an approach would be of value to users of annual reports.

*11. Respondents are asked for their reactions to the options for change relating to an enhanced model of corporate governance reporting, as described in Section III, Part D.*

We are supportive of the principles of this model but would refer you to our key points above in relation to how we believe such an approach could be best applied in practice.

*12. To the extent that respondents support this model, what challenges may be faced in promoting its acceptance? Also, what actions may be necessary to influence acceptance or adoption of this model, for example, by those responsible for regulating the financial reporting process?*

The principle challenge is that different jurisdictions have different legal and regulatory frameworks. In order to promote such a model, engagement is required with key stakeholders including investors, regulators and corporate entities.

*13. Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?*

Yes, the independent verification of the report would increase the value of the information provided to the users.

*14. Respondents are asked for their reactions to the need for, or potential value of, assurance or related services on the type of information discussed in Section III, Part E.*

We refer you to the recommendation from the ICAS Future of Assurance Working Group, that users of annual reports would benefit from auditors providing an opinion (not audit) that the rest of the information contained in an annual report is balanced and reasonable. It is appreciated that separate additional auditor reporting requirements might also develop in relation to some of the issues mentioned in this section of the consultation paper.

*15. What actions are necessary to influence further development of such assurance or related services?*

There is a need to seek effective engagement with stakeholder groups. ICAS has held discussions with various investors in the UK and indeed representatives from the investor community were represented on the ICAS Future of Assurance Working Group. The vast majority expressed their support for the Working Group's proposals. Ultimately, such groups are the main beneficiary of audit reports and therefore they must be actively involved in the debate on such matters.

We also believe that the IAASB has to closely monitor developments in related fields and in particular those in relation to integrated reporting.

*16. Respondents are requested to identify benefits, costs and other implications of change, or potential challenges they believe are associated with the different options explored in Section III.*

In relation to the auditor being asked to provide assurance (not audit) on the rest of the annual report we do not envisage that this would result in a significant additional cost on business. Additionally, we do believe that the benefit to users would outweigh any such additional costs in any event as it would give them a greater insight into the credibility of the additional information provided by management which can now run to many pages. It would also help to ensure that management does not seek to cherry pick what information is reported. Additionally, we do not envisage significant costs associated with implementation of the rest of our proposals.

*17. Do respondents believe the benefits, costs, potential challenges and other implications of change are the same for all types of entity? If not, please explain how they may differ.*

No, we do not believe that these are all the same for all types of entity. The additional reporting requirements that we believe should be introduced are restricted to the audits of listed entities. We believe that for such entities the benefits of providing this additional reporting would outweigh the additional costs that will be incurred. Ultimately, any changes which are introduced must be proportionate.

*18. Which, if any, of the options explored in Section III, either individually or in combination, do respondents believe would be most effective in enhancing auditor reporting, keeping in mind benefits, costs, potential challenges and other implications in each case? In this regard, do respondents believe there are opportunities for collaboration with others that the IAASB should explore, particularly with respect to the options described in Section III, Parts D and E, which envisage changes outside the scope of the existing auditor reporting model and scope of the financial statement audit?*

We would reiterate our preference for the proposals which we have detailed on the first page of this submission.

*19. Are there other suggestions for change to auditor reporting to narrow the —information gap perceived by users or to improve the communicative value of the auditor's report?*

We refer to our key comments above. These were based on work undertaken by a working group which contained representatives from each of the main stakeholder groups i.e. investors, corporates, the profession, academia and a journalist representing the views of the general public. There is also a clear need for the IAASB to work closely with other bodies who are currently considering options in this area e.g. the European Commission and the PCAOB.