

Overall Comments

A. Observations on paragraph 3 - quoted below

"It is notable that the call for change initially came primarily from institutional investors and financial analysts who are looking to auditors to help assist in navigating increasingly complex financial statements and point out the areas on which the auditor's work effort was focused – particularly on the most subjective matters within the financial statements. However, there are other "users" of the auditor's report, including securities regulators, lenders and other creditors, and public sector authorities, who will have an interest in developments in this area, as will other stakeholders, including preparers, those charged with governance (TCWG) of an entity, and audit regulators."

Not the Auditors Job

The auditor's job is to report on fair presentation in accordance with accounting principles. The fact that accounting principles are (way too) complex is neither the auditor's job nor responsibility. That is the responsibility of the accounting standard setters.

Expecting the auditor to help certain subsets of users (over the conflicting interests of other subsets of users) "in navigating increasingly complex financial statements" is both a conflict of interest (between some users and all users) and not within the auditors expertise.

If institutional investors need help "navigating increasingly complex financial statements" the solution is to more training for institutional investors. It is their job to understand financial statements, no matter how complex. And if statements are too complex, it is the fault of accounting standards and accounting standard setters, who should address the complexity. Auditors have no special knowledge in this area, and in particular are not trained as either investment advisors or financial analysts.

An auditor can give an opinion on whether or not something is presented in accordance with the accounting rules. Interpreting what that means is the job of the user, particularly the job of financial analysts, securities regulators, preparers (in particular) and audit regulators (who care not about the complexity or meaning of financial statements, but about whether the auditor has followed the auditing rules.)

Further, those who have made accounting standards so complex are the people listed as now needing help from the auditor to understand the complicated standards they have set. (The standard setting boards are made up representatives of preparers, financial analysts and so on, not auditors.)

All the Wrong Users

The (primary) users of the financial statements are (all of) the shareholders. Yet Paragraph 3 ignores "all" the shareholders, and instead focusses on a series of special interest groups who also may use financial statements. These are listed as:

1. institutional investors
2. financial analysts
3. securities regulators
4. lenders
5. other creditors
6. public sector authorities
7. preparers
8. those charged with governance (TCWG)
9. audit regulators

Nowhere are the shareholders mentioned - the primary users and those to whom the audit report is addressed.

If the people listed are having trouble understanding financial statements, they need more training to improve their understanding of accounting rules. They should not expect that the auditor has secret information which will explain it.

IFRS, in "The Conceptual Framework for Financial Reporting," states:

OB2 The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

Financial reporting standards are directed to the needs of "existing and potential investors, lenders and other creditors" and only for "making decisions about providing resources to the entity." Deciding that there is a whole other list of special interest groups that the auditor needs help goes past the capabilities of accounting standards.

The list of users specified includes many, many users; with many different and varied "needs" (they apparently all need someone else - the auditor - to do their job for them.) However, accounting standards are not developed to meet their unique needs, only for the purposes described in OB2.

And deciding that preparers need their auditors to guide them in understanding the financial statements, and presumably helping them select and apply the standards, is an independence violation.

The only proper answer an auditor could give to the question - "Gee, accounting standards are really complex, can you explain what this means to me?" would be - "I agree, they are too complex. I don't understand either."

"Point out the areas on which the auditor's work effort was focused – particularly on the most subjective matters within the financial statements."

First - under IFRS there will be a critical accounting estimates and judgements note which will describe this. Presumably, if the auditor thought something was missing they would have insisted on a change.

Second - the auditors' work effort may not be focussed on subjective matters. The auditor may spend time on accounts receivable or inventory, for instance, only to find that the numbers are right (and not subjective.)

For something that is highly subjective - maybe a big uncertain lawsuit - maybe little work will be done (there may be nothing that can be done other than to find it is big and uncertain) other than making sure the matter is carefully disclosed.

B. The expectation that auditors have "secret knowledge" they can share with others.

There seems to be an underlying premise that auditors have secret knowledge of business conditions that they are refusing to share with others.

This is not true. There seems to be a mix up in the document between audit risk and business risk. And a presumption that the auditor revealing stuff about their perception of audit risk will help institutional investors and others assess business risk.

IAS 315 4.b defines business risk as:

"A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies."

IAS defines audit risk as:

“The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.”

By definition, audit risk and business risk are different.

First - the audit risk model is primarily about letting the auditor do less audit work in low risk areas. It is not about helping financial analysts. It is useful to the auditor in determining the nature, timing and extent of tests, but not for other uses. Understanding how the audit was done is only useful to evaluate if a proper audit was done.

Second - not all business risks are audit risks. There are lots of “business risks” that the auditor pays no attention to. There may be overlap, but again, an understanding of how the auditor assesses audit risk does not lead an investor to a better understanding of business risk.

Third - many users will not care about audit risk, as it may not be a business risk relevant to their investment decision.

Finally - if there is an overlap between business risk and audit risk, the auditor only investigates whether the business risk has caused the financial statements to be misstated, that is, the audit risk part. The auditor does not investigate the business risk as a business risk, and can make no sensible commentary about it. Other than - Gee it's risky. All of business is risky; that's why auditors not entrepreneurs.

The problem with running a business (being an entrepreneur) is that everything is risky. Businesses get into trouble when a risk, previously not thought significant, turns out to be so. If the users listed in paragraph 3 expect the auditor to point out all risks (and apparently they do), including those not now thought to be significant (but which later turn out to be so and then to sue the auditor for not noticing) auditors will respond with a very long list of risks. And a really long, and really, really expensive, audit report.

C. Paragraph 4 is preposterous

Implying that the sovereign debt crisis is somehow linked to “transparency” in the audit report is beyond silly - to the point of being irresponsible. The IAASB is creating an expectation gap that can never be filled. Implying that the sovereign debt crisis would not have occurred if the audit report had been longer - as paragraph 4 does - is beyond preposterous. Many people have been warning for many years that government deficits and pension promises were un-sustainable. Others have stated the opposite. Implying that auditor commentary in the audit report on government financial statements would have prevented the sovereign debt crisis is similarly preposterous.

This is as preposterous as the IASB promising that adoption of IFRS would reduce the cost of capital. They also promised that adoption of International Public Sector Accounting Standards would have the same result. Maybe the sovereign debt crisis is their fault.

D. Some examples

Thomson Reuters Corporation, a Canadian public company, reporting under IFRS describes roughly 50 Significant Accounting Policies in Note 1 and eight Critical Accounting Estimates and Judgments in Note 2 (two of which are reproduced below) as well as reference to future changes to accounting policies, disclosure of sensitivity analysis of financial instruments, contingencies, commitments and guarantees (5 of these) and three subsequent events (as well as many other matters). All of these matters represent significant matters (or they would not be disclosed) and thus (most if not all) should be mentioned by the auditor in the report.

For instance - from Note 2:

“Allowance for doubtful accounts and sales adjustments

The Company must make an assessment of whether accounts receivable are collectible from customers. Accordingly, management establishes an allowance for estimated losses arising from non-payment and other sales adjustments, taking into consideration customer creditworthiness, current economic trends and past experience. If future collections differ from estimates, future earnings would be affected. At December 31, 2011, the combined allowances were \$145 million, or 7%, of the gross trade accounts receivable balance of approximately \$2.1 billion. An increase to the reserve based on 1% of accounts receivable would have decreased pre-tax earnings by approximately \$21 million for the year ended December 31, 2011."

Management clearly thinks this is a significant (and also material) item - or they would not have provided disclosure. Accordingly, the auditor should refer to this, perhaps as follows:

Valuation of Accounts Receivable

As disclosed in Note 2, in 2011, the Company has accounts receivable. As described in note 2, the company must make an assessment of whether accounts receivable are collectible from customers. This assessment, as described in the Company's summary of significant accounting policies, is judgmental. The company has disclosed that management establishes an allowance for estimated losses arising from non-payment and other sales adjustments, taking into consideration customer creditworthiness, current economic trends and past experience and that if future collections differ from estimates, future earnings would be affected. The Company has disclosed that an increase to the reserve based on 1% of accounts receivable would have decreased pre-tax earnings by approximately \$21 million for the year ended December 31, 2011 and such an impairment would have a material negative effect on the Company's statement of financial position and statement of comprehensive income, but would not impact its cash flow from operations.

Also from Note 2:

Income taxes

The Company computes an income tax provision in each of the jurisdictions in which it operates. However, actual amounts of income tax expense only become final upon filing and acceptance of the tax return by the relevant authorities, which occurs subsequent to the issuance of the financial statements. Additionally, estimation of income taxes includes evaluating the recoverability of deferred tax assets based on an assessment of the ability to use the underlying future tax deductions before they expire against future taxable income. The assessment is based upon existing tax laws and estimates of future taxable income. To the extent estimates differ from the final tax return, earnings would be affected in a subsequent period. In interim periods, the income tax provision is based on estimates of full-year earnings by jurisdiction. The average annual effective income tax rates are re-estimated at each interim reporting date. To the extent that forecasts differ from actual results, adjustments are recorded in subsequent periods. The Company's 2011 effective income tax rate was not meaningful due to the impact of a \$3.0 billion goodwill impairment charge, most of which is non-deductible for tax purposes. Excluding the goodwill impairment charge, the 2011 effective income tax rate on earnings from continuing operations was 16.8%. A 1% increase in the effective tax rate, excluding the goodwill impairment charge, would have increased 2011 income tax expense by approximately \$19 million.

Again management would not have disclosed this unless it was material. Accordingly the auditor should say something like:

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affected in a subsequent period. In interim periods, the income tax provision is based on estimates of full-year earnings by jurisdiction. The average annual effective income tax rates are re-estimated at each interim reporting date. To the extent that forecasts differ from actual results, adjustments are recorded in subsequent periods. This assessment, as described in the Company's summary of significant accounting policies, is judgmental. The Company has disclosed that the Company's 2011 effective income tax rate was not meaningful due to the impact of a \$3.0 billion goodwill impairment charge, most of which is non-deductible for tax purposes. Excluding the goodwill impairment charge, the 2011 effective income tax rate on earnings from continuing operations was 16.8%. A 1% increase in the effective tax rate, excluding the goodwill impairment charge, would have increased 2011 income tax expense by approximately \$19 million. Such a change would have a material effect on the Company's statement of financial position and statement of comprehensive income and its cash flow from operations.

As there are at least 60 (probably more like a 100) of such matters disclosed by the preparer; presumably the auditor would refer to all of these, in addition to other matters not mentioned by the preparer that the auditor felt were relevant. The Thomson Reuters Corporation financial statements are 133 pages long. Presumably, with full disclosure of risk, the auditor's report would be longer.

Specific Questions

- 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?**

Information bias.

Information bias is a type of cognitive bias. It is the human tendency to seek more information, even if that information will not affect a decision. The IAASB is catering to this bias. Faced with their inability to predict the market, institutional investors have concluded that the problem is that they need more information, particularly information from the auditor's file. There is nothing interesting in the auditor's working papers; they are either a record of procedures performed or contain copies of client documents. The auditors risk assessment is of no interest to an institution investor, notwithstanding that they think it is.

The only beneficiary will be the auditor, who will benefit from a significant reduction in legal liability while enjoying significantly increased fees.

Impact on fees

The auditor is better protected the more commentary is in the report. Commentary that, accounts receivable may be misstated because allowance for doubtful accounts may be wrong is now in the notes to most financial statements, either generically or better specifically as a critical estimate or judgement. Adding all of these - there are hundreds - to the auditor commentary will be both expensive (partners will make more money and more staff will be hired) and better protect the auditor from lawsuit.

How can one disagree?

Costs

Financial analysts and institutional investors are asking for more from the auditor. The auditor will phrase this additional advice in a way to escape any liability. The additional costs will be significant. These are passed on to the auditee, and finally to the shareholders - who make less money than they otherwise would. While the auditor makes more.

Should all the shareholders pay the costs for the (excessive) information needs of a few, some of whom are not shareholders?

Auditors will probably agree. As their fees and earnings will increase, while their exposure to liability decreases.

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.

It depends if you wish to cater to the information bias of a series of special interest groups - institutional investors for instance - or if you wish to make the auditor report understandable to the shareholders as a group.

If it is the latter, the audit report should be simplified so readers can understand it. The reading ease, as measured by the Flesch Reading Ease score, or the readability, as measured by the Flesch/Kincaid Grade Level score, of both the proposed and current report is bad. See the table below.

	Old report – 3 paragraph	New report – 6 paragraph report	Proposed 4 page report
Reading ease – higher than 50 is good, lower than 30 is bad	16.9	6.2	21.2
Interpretation	Very bad	Very, very bad	Bad
Readability – 10 or lower is good	16.4	20.3	17.1
Interpretation	Less than 20% of the population can understand - bad	Less than 20% of the population can understand – bad – worse than before	Less than 20% of the population can understand – bad, slightly better than the 6 paragraph version, but still worse than before

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?

No, see above

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?

I suspect the matters addressed will rapidly multiply, and become standard and used in all audits without change.

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?

No, see above

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?**

Audit reports will initially, until all the boilerplate is developed, take longer to prepare - longer as in not as timely.

Once the boilerplate is developed and shared amongst the firms (the firms will all read each other's reports and pick the best bits) it will just take longer - longer as in more time and increased fees.

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?**

Once the boilerplate is developed, it can easily be applied to all audits, to better protect the auditor.

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?**

Prescient information about going concern

There also seems to be an expectation that the auditor has secret knowledge about the future, and particularly about whether the entity is a going concern, and that they are perversely refusing to share with others.

First, the auditor has no special ability to predict the future. Research done in Canada in the 1980s showed that companies with a "going concern" note were less likely to go bankrupt than those without. Proving that the factors that cause business failure are not predictable - though many try (without long-term success) to invent models that will predict this.

Second, no one can predict the future. What passes for successful predictions are lucky guesses.

The job of predicting future business success is the job of institutional investors and financial analysts. Yet they continue to prove that they cannot do this. In Canada in 2010 (according to SPIVA) only 2% of mutual funds beat the index over 5 years.

"Because not all future events or conditions can be predicted, this statement is not a guarantee as to the Company's ability to continue as a going concern."

First - as stated above, auditors have no special ability to predict the future, and therefore have no ability to determine whether or not a company is a going concern, unless business has already failed.

Second - including a standard warning in all audit reports that the company may not be a going concern is of no use. All companies, whether in precarious financial position or not will have the same words in the audit report - meaning that the words are meaningless

Third - the statement "Because not **all** future events or conditions can be predicted" is flawed. It implies that some future events can be predicted, and that is patently false. The future cannot be predicted, though sometimes good (lucky) guesses are made. It is misleading to imply that either preparers or auditors can do so.

Fourth - and most obviously, whatever commentary an auditor may make about going concern, if the commentary is followed by a denial that "**this statement is not a guarantee as to the Company's ability to continue as a going concern**" any meaning is sucked out of the previous sentences. The audit commentary on going concern becomes meaningless.

The statement proposed for the audit report has absolutely no meaning. Made worse by the fact that it will appear (as boilerplate) in every audit report.

From the auditor's perspective this disclaimer affords significant protection. Auditors are now entirely off the hook if a company suddenly becomes not a going concern - because they have warned of this in each and every audit report. Many thought auditors were pretty safe because most financial statements now include such a warning in the notes, which was pretty good protection for the auditor. Being able to repeat this disclaimer in the audit report is significant protection for the auditor.

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 my comments on information bias. This information can only be used to judge if the audit was done right. But if clients are prepared to pay auditors lots more for this, who can refuse.

There is protection from liability for the auditor in this as well. If later, someone wishes to argue that the auditor did a bad audit, the response is, the reader should have known - what was done was described in the report. Read the report.

10. What are your views on the value and impediments of the suggested auditor statement in relation to other information?

Multiple additional report qualifications

Many auditors were pleased when the new audit report included new disclaimers, such as stating that auditors are not responsible for fraud (because management was) and that no opinion is given on internal control etc.

The proposed report includes multiple additional disclaimers, which auditors have to be pleased with, as it provides additional layers of protection.

The disclaimers are:

- A denial responsibility for going concern; "Because not all future events or conditions can be predicted, this statement is not a guarantee as to the Company's ability to continue as a going concern."
- A denial of any responsibility for any commentary on components: "Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures."
- Each of the component commentaries is effectively a denial of responsibility for the matter commented on - which will lead to a proliferation of such carefully crafted commentary denials.

- A denial for the responsibility of finding misstatements: “Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists.”

Not sure how this helps users, but fantastic protection for auditors.

- 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?**

These serve only to de-emphasize the responsibility of the auditor.

- 12. What are your views on the value and impediments of disclosing the name of the engagement partner?**

There is probably no group of people on earth who pay more attention to personal liability, and who engage in the most extreme measures to protect their personal assets from lawsuit, than partners in audit firms. Audit firms have the reputation of being the most difficult entities to sue.

They need no further emphasis their “personal accountability.” Any increased emphasis on “personal accountability” will only lead partners to take further steps to protect their personal assets. Even managers in accounting firms know to begin to take steps to shield their personal assets, and do so long before they become partners.

The concern that “In particular, some point to a perceived reduction in the responsibility of the firm and the possibility of increased legal liability for the engagement partner in some jurisdictions” is entirely valid. Large firms will find ways (if they are not already doing this) of blaming the (sacrificial lamb) partner and arguing that the “firm” is not at fault.

Further, what institutional investor (for instance) will know who “John Doe” (the partner responsible) is. Particularly, if firms stop emphasizing the firm name to protect firm assets. This will not have the intended effect, and can only be used by firms to escape liability.

That said, please do so - there are so many ways this can be used to further protect against liability.

- 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?**

Being able to disclaim responsibility for the failures of other auditors can only help protect the lead auditor.

- 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?**

Helps to de-emphasise the auditor’s responsibility and emphasized all the disclaimers of liability.

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?**

Does not matter.

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? (

Consistency will occur as boilerplate is used to write the reports.

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?

Does not matter.

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 question 7.