PKF

Accountants &
business advisers

Mr James Gunn
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Dear James

Re: IAASB Invitation to Comment (ITC): Improving the Auditor's Report

PKF (UK) LLP is a leading firm of accountants and business advisers. It is one of the major audit firms in the UK, with clients ranging from AIM and fully listed companies, and public and not-for-profit organisations to owner managed businesses. PKF (UK) LLP is a member firm of the PKF International Limited network of legally independent firms.

We welcome this opportunity for dialogue and we are supportive of exploring changes to the auditor's reporting model. We would note that there are a number of bodies currently considering changes to the auditor's report, including those at the European level, in the UK and in the United States. In the interests of users and of comparability, it will be vital for all regulators concerned to achieve the best possible harmonisation if the IAASB's approach is to work internationally. We consider that this could best be achieved by the IAASB keeping any proposed standard as flexible as possible, in particular to allow for jurisdictions with stronger corporate governance frameworks in place (see point (a) below) to build on the reporting by Those Charged with Governance (TCWG) of an entity rather than duplicating such reporting. We further encourage the IAASB to consider and promote the need for additional auditor services, beyond the financial statement and internal control over financial reporting audits (SARBOX), where such services may increase investor confidence in the capital markets, as a means to address some of the apparent concerns raised by users of financial statements and the auditor's report thereon.

There are several matters which we would like to draw your attention to before we respond to the detailed questions posed in the IAASB Invitation to Comment (ITC).

a) First and foremost we consider that the general premise of the auditor's current role is to provide assurance on information provided by management and governance bodies. If this is to change, as is suggested by the ITC this would seem to be changing the "system" which currently comprises reporting by entities in accordance with set standards and requirements and assurance on that reporting. We consider that focusing on the assurance aspect only, and auditor reporting specifically, is starting in the wrong place, and potentially creates unintended consequences. Reporting by entities needs to be improved – assurance over that reporting is only one way of achieving compliance and protecting the public interest. In particular, corporate governance standards need to be enhanced and become more consistent across jurisdictions. Whilst we appreciate that the IAASB cannot directly impact corporate governance reporting as auditing

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standard setters generally do not have jurisdiction over entities themselves, more focus should be placed on promoting regulatory consistency around the world. The type of change necessary to appropriately respond to the information needs of users and narrow the expectations and information gap needs to go further and cannot be achieved by the auditors alone. We consider that the role of TCWG is paramount to further meaningful change and therefore it is important that efforts to improve auditor reporting are synchronized with improvements to corporate governance and financial reporting more broadly.

b) We are concerned that if auditors become responsible for the provision of original information this could blur the roles of management and the auditor in the eyes of investors. Whilst paragraph 9 of the ITC states that "there is a need to preserve the separate responsibilities of management and TCWG, as providers of original information, and the auditor, respectively", we do not believe this is evident in some of the proposals made later in the paper.

c) Currently, auditors' reports on general purpose financial statements are addressed to the members who are therefore regarded as the primary users of the financial statements. The introduction to the ITC implies a much wider set of users; for example including lenders and other creditors. The remainder of the document then uses the term "users" and we presume this is this wider group of users. While financial reporting principles generally and some auditing standards (e.g. materiality) typically acknowledge a broader range of users, the focus in the proposals in the ITC seems to be aimed at this broader group which is a significant change from the current position. Whilst we appreciate that this is primarily a jurisdictional issue, if this is the actual intention then our view is that other matters need to be considered such as auditor liability.

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?*

We are supportive of exploring changes to the auditor's reporting model, particularly with a view to narrowing or closing the expectation gap, but as noted in our introductory comments we consider that changes to the auditor's report and implied changes to the auditor's role must not be seen in isolation. Any improvements must be synchronized with improvements to corporate governance and financial reporting more broadly. In our view to do one without the other places inappropriate responsibility on the auditors when first and foremost it is the responsibility of TCWG to oversee the management of the business and communication with interested parties.

We consider that the cost implications are likely to be higher if the commentary is totally initiated by the auditor as opposed to either confirming the appropriateness of what has been disclosed in an Audit Committee Report or adding thereto. Whilst we accept that the audit report is the auditor's document to draft as he/she sees fit there is no doubt that as content expands so will client discussion on the information contained therein.

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.*

There must be a coordinated approach that encompasses all relevant parties such as regulatory bodies, standard setters, management, TCWG and securities exchanges. Securities exchanges typically govern additional reporting and governance requirements not covered by financial reporting standards.

More should be done to enhance requirements set by the very exchanges on which investors rely to provide access to trading. Expanding the auditor's responsibilities may be the only route available to the IAASB, but should not be explored in isolation simply because the profession is well governed and easier to control.

Bearing in mind the comments we made earlier regarding the "users" to which the IAASB refers throughout the ITC we would question whether the time has come to consider if one report can meet all the varying demands which seem to be being made. This would, of course, require a far more fundamental overhaul of the overall reporting framework and examination of the auditors relationship with the various stakeholders.

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)*

Under existing ISA requirements auditors discuss matters of significance related to the performance and findings of the audit with TCWG and we understand that the company's shareholders may be interested in the nature of some of these discussions. However, we do not consider that the Auditor Commentary should be used to provide original information e.g. on specific accounting sensitivities which should more appropriately be described and explained by management. We therefore consider that the focus of any auditor commentary should build on the existing discussions with TCWG, as required by ISA 260 "Communication with those charged with Governance", as discussed in more detail below.

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.)*

We noted above our view that there should be a clear link between the existing ISA 260 reporting to TCWG and any auditor commentary. We consider that the matters referred to in the ITC under paragraph 45 would be dealt with in the ISA 260 report to TCWG. We would propose that the following may be appropriate (note that this is one of the alternative proposals currently being put before the European Parliament in their deliberations on the subject). "For each significant audit risk – as defined in accordance with the international standards on auditing there should be:

i) a description of the most important assessed risks of material misstatement, including assessed risk(s) of material misstatement due to fraud;
ii) a summary of the auditor's response to those risks; and
iii) key observations from that audit work.

Where relevant to the above information provided in the audit report on each significant audit risk, a clear reference to the relevant disclosures in the financial statements shall be provided.

The information referred to above in respect of most important assessed risks of material misstatement that is to be disclosed in the audit report shall be selected from the matters discussed with the audit committee of the entity in accordance with the requirements of the international auditing standards 260".

We find the comments in paragraph 44 confusing as, by definition, we would assume that an area that involves significant audit judgement or for which the auditor has assessed the risk of material misstatement as high are significant risk areas.

The less guidance there is on this topic the greater the risk that there will be local variations in interpretation and hence a lack of international comparability.

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.)*

The greatest difficulty with the Auditor Commentary as currently proposed is judging what will be of interest to users. This is one of the reasons we would suggest that the Auditor Commentary may be better targeted by responding to issues raised/considered by TCWG in their report as they should be more aware of the concerns of its investors, if the ISA 260 based reporting as referred to in 4 above is considered inadequate.

The examples given in the ITC vary between those that would currently be regarded as a potential emphasis of matter (litigation), a commentary that arguably would be better dealt with by management in the accounts disclosures (goodwill) to an audit judgment issue (valuation of financial instruments). Looking at the detail, which we appreciate is merely illustrative, we considered raised more questions in some cases e.g. in the latter case the fact that the management's recorded amount fell within the auditor's range might still lead the reader to question which end of the range? We express our concerns later in this document in relation to including comments relating to the involvement of other auditors.

We would generally propose that any commentary should build on some distillation of the ISA 260 findings as reported to TCWG, which in the first instance we would expect to see included by TCWG in their own report. Please note that we would not want to go so far as having the ISA 260 made public as there is a risk that this would itself become boiler-plate in nature.

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.)*

We are concerned that such commentary may blur the responsibilities between Auditors, Management and TCWG which could lead to confusion for investors. As we noted earlier we consider it is important for the responsibilities of Management and TCWG to be reinforced and any proposed new reporting format should not detract from this.

We consider that there will be some additional costs, such as extra time spent at senior level in both the audit firm and in the audited entity. At this stage we do not consider it is possible to estimate the potential time, and hence cost, involved particularly given that this is likely to increase dramatically if any of the proposed wording within the report is contentious. We would anticipate that the report would only be finalised after the final audit committee and then be subject to "agreement" by the board. Given that the intention is not for these reports to contain a significant amount of "boilerplate" type reporting, which could result if timing is an issue, we suggest that the IAASB talk to listing authorities about the potential consequences of its proposals.

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.)*

As we have noted above we have concerns regarding whether auditor generated commentary is the most appropriate course of action.

That aside, whilst we would generally support the view that reporting requirements should be the same for all entities, it is debatable whether such commentary would be of any benefit to, say, an owner managed business where the individual to whom the auditor is reporting is the same as TCWG. In such a case there may be some benefit to other "users" but again we have expressed our concern over effectively addressing the audit report to a wider audience.

As we presume that the intention would be for any new standard to be "proportionately applied" it could be argued that it could encompass all entities – the less complex the entity the less one would expect there to be to report although we would expect most auditors to have identified some significant risks. We would assume that the potential to use an "emphasis of matter" paragraph where necessary would remain.

We do not consider that the auditor discretion option is appropriate as this will reduce comparability and could lead to a reader of the auditor's report incorrectly assuming that there were no "significant matters" arising simply because the auditor decided that no reporting was appropriate. This could also result in an entity being "required" by one firm to have an Auditor Commentary and another not, putting management in a position where they could play one audit firm off against another. Our experience tends to indicate that clients, particularly smaller ones, do not like to be seen to be "different" from their peers/competitors and might well regard the proposed commentary with some suspicion. We do not know what research has been done by the IAASB outside the users of PIEs to determine whether, for example, owner-managed businesses would find such commentary of use and wonder if further investigations are required.

If the PIE only route were to be pursued then we consider there would need to be an agreed upon definition of a PIE. At present there are numerous definitions of a PIE and this is likely to cause confusion and problems of consistency for the application of the Auditor Commentary. It is the case that even some individual audit firms have their own definition of what entities are PIEs

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.)

The financial reporting framework should ideally specify requirements in this area. There is a risk that such an audit requirement without consideration of the specific financial reporting framework will lead to original information being supplied by the auditor. Certain frameworks may contain implicit rather than explicit requirements about preparers' responsibilities (e.g. under US GAAP there is no explicit requirement for management to perform a management assessment of going concern, although this may be implied). In addition, the criteria for assessing going concern under different reporting frameworks are different. This should be explained in the financial statements if the information is considered to be of such importance to users. The auditor's report should not be used as a tool to compromise for inadequate financial reporting standards. Further, many frameworks require disclosure of material uncertainties and estimates and the fact if an entity is not a going concern, and auditor reporting is already required where the use of going concern is inappropriate. We do not consider that an auditor statement regarding the appropriateness of management's use of the going concern assumption adds any information of value.

An alternative may be to:

i) Explain in the auditor's report the requirements under the applicable reporting framework (e.g. implicit or explicit requirement for management to make an assessment of going concern).

ii) Describe in the auditor's report the auditor's responsibilities more clearly. ISA 570 provides very useful guidance to auditors addressing going concern under different reporting frameworks, including the auditor's responsibility to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption irrespective of the financial reporting framework requirements. Failure to obtain the required evidence (e.g. this may be the case if management refuses to make or extend an assessment when requested by the auditor) will impact on the audit report. Explaining this to users may go a long way in providing some of the "comfort" which seems to be required.

iii) In situations where management's unwillingness to make the requested assessment does not impact on the auditor's opinion, emphasise in the auditor's report that management was unwilling to make or extend its assessment, even though the auditor concluded that it did not impact in the opinion. This results in factual information being stated, rather than subjective auditor views.

In addition, in the illustrated auditor's report we consider that many clients would take exception to the proposed heading "Material uncertainties related to events or conditions that may cast significant doubt on the company's ability to continue as a going concern" as inflammatory, as it could be read to imply that such uncertainties exist. This may, of course, merely be a client education point.

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.)*

Management should make the necessary disclosures and auditors should then audit this information. The auditor's report should not be used as a tool to compensate for inadequate financial reporting standards. We are also unclear as to what is meant by the situation set out in para. 30 of the ITC, which states that "the auditor may have determined that no material uncertainty exists, yet events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern". If such events have been identified, and there is no uncertainty surrounding them then surely does this not imply that the entity is probably not a going concern?

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

We are supportive of auditors being more specific about the work they have done in this area. Providing users with better information will help improve clarity.

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.)*

We are supportive of the enhanced description of relevant responsibilities in order to clarify how responsibilities are allocated and to narrow the expectation gap.

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

As a UK firm of auditors we are already familiar with providing such a statement through a combination of the local legal requirements and the requirements of ISA (UK & Ireland) 700.

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.)*

Under ISA 600 it has been clarified that the group auditor takes sole responsibility for the group audit opinion. Indicating the name of the other auditors would seem to be misleading and potentially dilutes the value created by an enhanced ISA 600. It may also be seen as a weakness within a particular audit. In particular there may be the perception that the responsibility of the group auditor is diminished as a result of which we are opposed to reporting on the involvement of other auditors.

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.)*

While the wording is important to help address expectations gaps and for users to understand the respective responsibilities of management, TCWG and auditors, the inclusion of all the suggested wording in the audit report lengthens it, potentially unnecessarily, and is regarded by many as boiler-plate.

We suggest that the audit report could note a link to a website, be it of a national standard setter or perhaps that of the IAASB, where more detail can be found. Where appropriate, the wording should aim to address expectation gaps including those that may potentially arise as a result of the IAASB's proposals for audit reports. This maybe an area where some flexibility needs to remain, at least initially, given that this is to be an international standard and we would assume that the internet may not always be totally reliable in all jurisdictions.

Given its importance we would prefer to include the text on management's responsibilities relating to going concern in that section of the report which is currently cross-referenced thereto.

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.)*

Having the auditor's opinion at the start of the report should help put any subsequent comments in the Auditor Commentary in context of the overall 'pass/fail' opinion. However, we would put forward two further considerations. There is the potential that a reader, having satisfied themselves of the "pass", does not continue with reading any of the more detailed comments. Second, in the UK at the present time if there is a significant uncertainty in relation to going concern this is closely connected with the main audit opinion. In the current proposed format any such concern would not be as prominent as it would appear later in the report which may imply its of lesser importance.

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.)*

Global consistency in auditors' reports is very important, but it is also important to allow for some flexibility and additional information (rather than jurisdictional changes to the core report content) e.g. in the UK for listed entities the requirement to opine on directors' remuneration. We also consider that there needs to be sufficient flexibility to enable those jurisdictions with stronger corporate governance frameworks to build those into the new reporting framework where possible.

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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 consider that the IAASB should mandate the ordering of items to assist with consistency, subject to our comments above regarding flexibility of content.

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.)*

Please see our response to question 7 above.

We appreciate the opportunity to comment on the consultation paper and we welcome the dialogue on the auditor's report. If you have any questions please do not hesitate to contact me.

Yours sincerely

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