

November 22, 2013

Small and Medium Practices (SMP) Committee Response to the Exposure Draft *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*

Introduction

The SMP Committee is pleased to respond to the IAASB on this Exposure Draft (ED).

The SMP Committee is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small-and medium-sized entities (SMEs). The constituents of the SMP Committee are small-and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMP Committee have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies from 18 countries from all regions of the world.

Effective changes to auditor reporting can only be made with due consideration of the needs of all major stakeholders. We particularly appreciate the Board's recognition of the need to consider the users of the financial statements of SMEs and the wide outreach that has been undertaken in developing this exposure draft. We acknowledge the explicit reference by the IAASB in considering whether the proposed ISAs can be implemented in a proportionate manner. We note that we have already provided comments to the *Invitation to Comment – Improving the Auditor's Report* in October 2012 and submitted responses to the Auditor Reporting Task Force in February, April and June 2013.

General Comments

Overall, we believe that the current proposals continue to retain a substantial emphasis on the users of listed entities financial statements. We recognize the heightened attention to auditor reporting in the recent economic environment and consider that within the constraints of being unable to change the audit mandate, aspects of the IAASB's suggested improvements should enhance the perceived value of the audit report and strike a reasonable balance between global consistency and national flexibility.

Our concern remains that the proposed expansion of auditor reporting, (with or without reporting of key audit matters,) may adversely impact the cost/benefit of SME audits and may also result in audit reports becoming excessively long.



Specific Comments

1. **Do users of the audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?**

In general, we believe that the new section on key audit matters is an appropriate response to the demand for auditors to provide more information to users of auditor's reports of companies listed on the capital markets. We are also supportive of key audit matters replacing the concept of auditor commentary and agree with the IAASB position that the auditor should not be the source of information about the entity in this section.

We are, however, concerned that there is a risk key audit matters may result in boilerplate reporting characterized by the same or similar matters being described for certain industries year to year. The result may be to add volume to the auditor report, but add little, if any, information of value to the end user. We acknowledge that new or potential investors may find such disclosures useful. In our view, the decision-usefulness of the "additional" information on key auditor matters provided to the users of the auditor's report needs to be the primary driver in the determination of key audit matters and the level of detail to be reported, while having due regard to the related costs and benefits of providing that information.

We agree that the requirement to include key audit matters should only apply to the audits of complete sets of general purpose financial statements of listed entities and are supportive of the IAASB's proposal for auditors to be able to voluntarily decide to communicate key audit matters in the auditor's report in all other ISA audits. That said we recognize that it is the responsibility of national authorities, rather than the IAASB, to prescribe which type of entities are required to communicate key audit matters. As noted in our response to the *Invitation to Comment (ITC) – Improving the Auditor's Report (October 2012)* it is widely acknowledged that there are generally few types of users of audited SME financial statements, and often these users already have a relationship with the entity such that they are able to obtain the information they need, whether included in an auditor's report or not.

Overall, we suspect that it is unlikely this option will be taken up by many SMEs as the real or perceived benefits are likely to be less and the associated costs, such as staff training and the increased utilization of more senior staff time, higher. In any case, the key stakeholders of SMEs may already be aware of the key audit matters through other means of communication. We therefore anticipate that the voluntary reporting of key auditor matters will be predominantly in relation to larger unlisted entities and that ISA 701 will not be applied in the majority of SME audits. Nevertheless, we accept that it may provide some auditors with the opportunity to add value through adopting what they perceive to be good practice in providing useful information for users.

In particular jurisdictions concerns remain that voluntary reporting might lead to confusion amongst stakeholders and perhaps increase the expectations gap. In addition, there are concerns that it may also create a competitive disadvantage for SMPs as larger audit firms will develop more experience in reporting key audit matters and are perceived to be providing a better service.



We note that as part of its intended post-implementation review the IAASB will consider whether wider application of the proposals, which are initially limited to audits of complete sets of general purpose financial statements of listed entities, would be in the public interest. We would strongly urge that this review includes a robust and rigorous cost/benefit analysis on the impact of ISA 701 on SMPs and SMEs.

2. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor’s judgment in determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?**

Overall, we believe that the proposed requirements and related application material in proposed ISA 701 provides an appropriate framework to guide auditor’s judgment in determining key audit matters and should result in reasonably consistent auditors judgments about what matters are determined to be the key audit matters, subject to the comments raised below.

The majority view of the SMP Committee is that specific matters to be addressed in this section should be left to the judgment of the auditor. This is consistent with the definition of key audit matters in proposed ISA 701 (paragraph 7). We are also supportive of ISA 701 stating that the key audit matters should include consideration of the areas identified as significant risks or involving significant auditor judgment.

A concern has been raised in regards to how practical it is to include areas in which the auditor encountered significant difficulty during the audit in determining and reporting key audit matters (ISA 701 paragraph 8.(b)) and whether the audit report is an appropriate medium to communicate this matter. We acknowledge that under ISA 260 *Communication with Those Charged with Governance* the auditor is required to communicate significant difficulties, if any, encountered during the audit with those charged with governance. Whilst in principle we recognize that this can be viewed as a key audit matter, if the issue has been resolved (despite, perhaps, being communicated in a management letter) it is debatable whether the audit report is also the place to disclose these difficulties. If the difficulty is significant enough to constitute a scope limitation then that requires a modification of the auditor’s opinion and consequently this difficulty will have already been highlighted in the presentation of the modified opinion.

We question the emphasis placed on the identification of a significant deficiency in internal control as a modification to the auditor’s planned approach (ISA 701 paragraph 8 (c)). We believe that this would not necessarily lead to a risk of material misstatement and raise the concern whether the audit report should be used to communicate this issue. We also believe it would be more appropriate to use the identification of a significant deficiency in internal control as an example, rather than as currently stated in ISA 701 paragraph 8(c) “including”.

In summary, we believe that subsections (b) and (c) of paragraph 8 in ISA 701 can be essentially subsumed under subsection (a).



3. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor’s report? If not, why?**

We believe the related application material in proposed ISA 701 provides sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters. It is particularly important that the IAASB emphasize that piecemeal opinions should not be given.

4. **Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking informational value, and why? Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.**

The illustrative examples of key audit matters are useful, especially that of Revenue Recognition Relating to Long-Term Contracts.

We recommend that if the auditors of a significant number of small-and medium-sized entities that are not listed entities voluntarily report key audit matters, then it would be worthwhile considering whether the illustrations are sufficiently relevant to SME audits.

5. **Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why? Are there other practical considerations that may affect the auditor’s ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?**

As noted in our response to question one, we agree that the requirement to include key audit matters only applies to audits of complete sets of general purpose financial statements for listed entities. We agree that it is important to have consistency in the application of the standards and therefore understand the rationale for requiring all entities to follow ISA 701 if key audit matters are communicated on a voluntary basis. We also recognize that it should encourage better communication generally between auditors, management and those charged with governance before an engagement commences.

However, we wish to stress that there are certain practical considerations for SMPs which impact the communication of the intention to report upon these matters in the engagement letter. There is a concern that until the audit is more advanced, the auditor may not have formulated an intention. We recommend that when key audit matters are communicated voluntarily, then if the auditor determines at a later stage that communication of key audit matters is in the best interests of users, there should be no barrier to doing so. We recognize that in jurisdictions where the auditor is



subject to legal confidentiality requirements, reporting key audit matters will only be possible with client acceptance in the terms of engagement.

We would recommend that the status of the proposed new ISA 701 in the ISAs needs to be clarified further where an auditor is prevented from exercising the free choice foreseen by ISA 701 and voluntarily applying the standard, for example, where national legislation precludes reporting key audit matters. Where this is the case, it needs to be clear and suitably covered in the standard whether ISA compliance can be claimed or not.

6. Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate?

- (a) If so, do respondents agree with the proposed requirements addressing such circumstances?*
- (b) If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor's responsibilities under proposed ISA 701 and the determination, in the auditor's professional judgment, that there are no key audit matters to communicate?*

We believe that it would be extremely rare for there to be no key audit matters to be communicated for a listed entity. We are happy with the current proposal for addressing such circumstances.

7. Do respondents agree that, when comparative financial information is presented, the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?

We agree that the auditor's communication of key audit matters should ordinarily be limited to the audit of the most recent financial period only, but that this is not made a requirement. We agree with the proposed wording in paragraphs A8-A9 of proposed ISA 701 and consider it is unlikely key audit matters identified in the prior period would continue to be of most significance in the current period audit, but that possibility ought to be allowed otherwise there would be no mechanism for its inclusion. It is important that any matter raised in the prior period, which is reconsidered in the current audit and disclosed, is not simply copied from the prior year, but rather is appropriately re-evaluated as a key audit matter for the current audit.

8. Do respondents agree with the IAASB's decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters, and how such concepts have been differentiated in the Proposed ISAs? If not, why?

In our response to the ITC we highlighted the risk of the Emphasis of Matter paragraph and Other Matter paragraphs being diluted if they were contained in the key audit matters section. We therefore agree with the IAASB's decision to retain these concepts. We agree that the most common use of the Emphasis of Matter paragraph is to highlight material uncertainties relating to



going concern and accept that this will now be replaced by a similar paragraph as part of a separate going concern section.

We are concerned as to the potential of materiality being considered and disclosed as a key audit matter. This is evident in the recent Deloitte LLP Auditor Report in the Vodafone Group PLC Annual Report 2013 where the amount of materiality is clearly stated in the Auditor Commentary section. We recognize that this was according to a UK Standard and not the ISA and that in ISA 701, materiality is not referred to in determining key audit matters (paragraph 8) or in the corresponding application and other explanatory material (A15 – A23). However, the application of materiality in the context of the audit is included as an example in proposed ISA 706 (Revised) in relation to other planning and scoping matters as being unlikely to be a key audit matter (paragraph A8). We believe it should not be an example and that it is sufficient for the application of the concept of materiality in an audit to be communicated to those charged with governance through the existing requirements under ISA 260. Furthermore, as stated in ISA 320, it is reasonable to assume that users of financial statements understand these are prepared, presented and audited to levels of materiality.

9. **Do respondents agree with the statements included in the illustrative auditor's reports relating to:**

- (a) ***The appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements?***
- (b) ***Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised))?***

In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.

We have no reservations with respect to the illustrations provided in ISA 570. We agree that information regarding the identification of a material uncertainty relation to going concern should be presented as part of the going concern section of the audit report, so as to afford it appropriate emphasis. It would be helpful for the IAASB to clarify in ISA 701 that going concern matters might also be a key audit matter when no material uncertainty has been identified.

Overall, opinion was divided on whether the audit report should include a specific statement on going concern, even when no issues had been identified as per paragraph 20 of ISA 570 (Revised) and the illustrations included in ISA 700.

We are concerned that the proposed wording for when no material uncertainty has been identified may inadvertently give the impression to users that more assurance has been obtained than is actually the case. Mandating such statements in all audit reports appears unnecessary, especially since in the majority of audits it is unlikely to be the most useful information auditors can communicate to users. It may also result in undue prominence being given to going concern, which may distort the reader's understanding and possibly increase the expectation gap.



We encourage the IAASB to give more consideration as to how to address this issue, ensuring sufficient reflection is given to user reaction to the proposed changes. The potential for user misunderstanding is also likely to be higher in the first year of disclosure, where key audit matters are not presented and where there are relatively unsophisticated users.

We acknowledge that the IAASB recognizes the need to monitor developments of the accounting standard setters and other key regulatory initiatives in this area and agree that there may be a need to revisit the concepts in proposed ISA 570 (Revised) to ensure these remain appropriate in respect of changes in different financial reporting frameworks.

10. **What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?**

We agree that it is important to clarify the auditor's responsibilities relating to going concern, but do not support including the proposed explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern being required in the auditor's report whether or not a material uncertainty has been identified. The inclusion of a sentence covering both management and the auditor could be misleading as these parties have distinctly different responsibilities. The auditor should not make a primary disclosure of matters that management is better placed to make.

11. **What are respondents' view as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?**

We believe that disclosure of the fact that the auditor is independent will be beneficial, not least by increasing transparency for users. It enables users to appreciate the ethical qualities to which auditors subscribe and so should increase the perceived value of the audit.

From an SMP perspective we do not foresee significant practical implications of including a statement that the auditor is independent of the entity. However, specifying each source of relevant ethical requirements may not be practical in all jurisdictions. The majority of SMPs will use a modified version of the IESBA Code of Ethics, which has been tailored to their local jurisdiction. However, some jurisdictions may not have a code as such but instead have provisions within various laws, code of conduct etc. It would be impracticable and unhelpful to require long lists to be provided; confirmation that the IESBA Code and any additional more stringent requirements applicable in the particular jurisdiction (see ISA 200.14 and A14) would be preferable in such cases.



12. **What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?**

While many advanced jurisdictions require disclosure of the engagement partners' name there are other jurisdictions in which this would be culturally difficult or inadvisable for other reasons. Overall, from an SMP perspective, we are neutral on this issue.

13. **What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?**

We believe that the proposed changes to ISA 700 are appropriate and consider that there is some value in communicating greater detail on the responsibilities of the auditor and key features of an audit as this may help narrow the expectation gap. As noted in our response to the ITC, the SMP Committee has a range of diverging views on whether standardized material should be allowed to be relocated to a website or an appendix. For example, some committee members believe that, while relocating this material would help reduce the length of the report, it is doubtful whether many readers would take the time to refer to the website or appendix, thus risking increasing the expectation gap. Also, on a conceptual level, some believe that relocation may be perceived as relegating the importance of such content, thus perhaps running counter to the IAASB's objective of enhancing the report. Others are concerned that removing text from the auditor's report (relocation to a website) when that text is required content in national law will not be permissible.

Conversely, some welcome the fact that reducing the profile of standardized material would enable the user to focus more clearly on valuable entity-specific content. In conclusion, we feel the diversity of opinion amongst the committee is indicative of the cultural diversity of our constituency. As such, we feel unable to advocate one particular global approach from an SMP perspective. We therefore support that ISA 700 (Revised) permits and recognizes the need for flexibility in individual jurisdictions and by national standard setters.

14. **What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20–45 and the circumstances addressed in paragraphs 46–48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?**

As noted in our response to the ITC we supported the view that the IAASB should mandate the ordering of items included in the audit report. We recognize the new position and need to consider different cultural requirements and that the structure and placement of certain elements in some countries will differ. We maintain, however, the importance of a degree of consistency in the ISA auditor's report. Global consistency should be encouraged wherever possible as the audit report is



the public face of the audit. The more constant the form of the message, the more likely it will be valued by users, both globally and locally.

We support the proposal to require specific headings in the auditor's report to ensure the required reporting elements can be recognised in all reports for audits conducted in accordance with ISAs, even if they are presented in a different order. We also agree with the prescriptive requirements in ISA 700 and that the IAASB has presented the requirements in a particular order that aligns with the suggested presentation in the illustrative auditor's report. We suggest that the order of the first two paragraphs in the illustrative report be reversed in order that the opinion follows an introduction identifying what has been subject to audit. This is more logical.

Overall, we believe the approach suggested will achieve a suitable degree of global consistency while also enabling national reporting requirements and practices to be accommodated.

Concluding Comments

We hope the IAASB finds this letter helpful in further developing proposals to enhance the quality, relevance and value of auditor reporting. In turn, we are committed to helping the IAASB in whatever way we can to build upon the results of this exposure draft. We look forward to strengthening the dialogue between us.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

A handwritten signature in black ink, appearing to read 'Giancarlo Attolini', is written over a horizontal line.

Giancarlo Attolini
Chair, SMP Committee