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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Barcelona

Meeting Date: March 1–2, 2010

Research on Auditor's Reports—Key Issues

Objective of Agenda Item

1. The objective of this Agenda Item is to obtain the Representatives' views on a number of key issues relating to this project. The discussion on this topic will follow the structure of this CAG paper.

Background

2. The CAG has not previously discussed this project. The IAASB established a Working Group in the second quarter of 2009 to analyze information and findings reported in four academic research studies commissioned earlier by the IAASB and the Auditing Standards Board of the American Institute of Certified Public Accountants. The Working Group comprises IAASB members from a range of countries. The IAASB considered the report of the Working Group on this project at its meeting in December 2009 (CAG Reference Paper, IAASB Agenda Item 4-A, Auditor's Report – IAASB Working Group Report).
3. The Working Group's report sets out:
 - (a) The information the Working Group considered, including:
 - (i) Reports for four IAASB/American Institute of Certified Public Accountants (AICPA) commissioned research studies on user perceptions about the standard unqualified auditor's report ("the SAR"). (These reports were previously circulated to the CAG, and electronic links to the reports are also provided at the end of this CAG Paper);
 - (ii) Other relevant information about auditor reporting and user perceptions thereof, including information about current auditor reporting models used in France, Japan and the United Kingdom; and
 - (b) Key messages about the SAR that the Working Group has identified from its analysis of the information.

IAASB Discussion in December 2009

4. The IAASB made the following observations from its consideration of the Working Group's report:

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- The debate about auditor reporting, and about the form and content of auditor's reports and their overall usefulness to users, is part of the wider debate about the role of the audit in today's economy and its inter-relation with financial reporting and corporate governance. Given the changes that have been occurring in both the financial reporting and corporate governance environments, it is important to consider the audit, and the needs the audit is designed to satisfy, in that wider context.
 - Taken together, the research studies provide evidence that the auditor's report is valued. The current audit reporting model seems to work as intended, where a qualified audit report provides the intended signal for users concerning the audited financial statements to which the report relates. The question, however, is whether the current audit reporting model addresses users' needs for additional information to help make informed investment and stewardship decisions. Therefore, the challenge is to consider ways to enhance the value of the auditor's report in that regard.
5. The IAASB considered it may be beneficial to understand user perceptions of the usefulness of the standard auditor's report in countries that use different auditor reporting models, and also market reactions to auditor's reports in those countries where possible.

The Working Group's View on the Way Forward

6. Based on the IAASB's discussion and considerations at its December 2009 meeting, the Working Group has identified a number of further considerations and possible future actions for this project. For example:
- Considering information from responses to the IOSCO Consultation Paper, "Auditor Communications" (September 2009). The Working Group believes this consultation will provide further information about investor views on the issues outlined above, and would like to encourage a dialogue with IOSCO's Technical Committee to further synthesize the information obtained from the consultation;
 - Identifying ways to be able to better understand the information needs of different types and classes of users and investor groups, as relevant to auditor reporting on financial statements; and
 - Considering the possibility of further research to examine user perceptions and/or market responses to auditor reporting models used in different countries.
7. As part of its consideration of future actions, the Working Group requests the views of the Representatives about the key messages and possible actions the Working Group has identified, as set out below.

Key Messages Concerning the Standard Unqualified Auditor's Report

8. The Working Group identified a number of key messages about the SAR from its analysis and synthesis of the underlying information. They are set out below, broadly categorized as "general messages" about the SAR and "specific messages" about the perceived usefulness of the SAR and views on auditor communications more widely. (CAG

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Reference Paper, IAASB Paper Agenda Item 4-A, Appendix 4 reflects these key messages in a summarized format together with links to the various research studies.)

General Messages

9. General messages about user perceptions of the SAR are:

- (a) Auditors' reports are valued by users, and particularly as to whether the report is qualified or not.
- (b) The unqualified audit report appears to be valued more for its existence rather than its content.

Users do not appear to read the auditor's report in detail, but merely note the fact that it exists in relation to the audited financial statements of a particular entity in which they have an interest.

As a consequence, users' judgments and decisions about an audited entity appear to be generally unaffected by the detailed content and the format of the SAR. The challenge is how to improve the *communicative* value of the report (see also the specific messages in paragraphs 12-13).

- (c) The expectations gap surrounding the scope and purpose of the audit of financial statements and the auditor's role and responsibilities, is persistent and very hard to change.

The expectations gap persists regardless of the explanations contained in the SAR about what an audit comprises, and about the respective roles of the auditor and the entity's management. There is some evidence that the extent of the expectation gap is increased, not narrowed, by the added information included in the SAR about management and auditor responsibilities.

- (d) User perceptions of the scope and quality of audits and their perceptions of quality of audit reporting seem inextricably linked.

Some hold the view that audit quality may be enhanced if auditors' reports contained more information of the type that users view as being useful or desirable for their purposes. However, there is no clear consensus about the types of additional information users would like the auditor to report on in the auditor's report (or what users would do with the additional information if they had it). Broadly speaking, users appear to want additional reporting of matters that are part of the audit process, and also of matters that are currently outside the scope of an audit of financial statements (see also the specific messages in paragraphs 12-13).

Specific Messages: Usefulness of the SAR and Auditor Communications

- 10. The following specific messages were identified, broadly linked to views on the usefulness of the SAR and views on auditor communications more widely.

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11. The current content of the SAR is not viewed as being useful. User perceptions about this appear to be shaped to some extent by factors that relate to the form and content of the report. For example:
 - (a) The wording of the report is often seen as “boilerplate” and there is a perception that some of the language in the report is too technical (i.e., there is lack of “shared meaning” of some terms used in the report). As a consequence, the auditor’s intended messages in the report are often not understood by users.
 - (b) Regarding technical terms contained in the auditor’s report, examples of terms that users appear not to understand very well are:
 - “reasonable assurance”
 - “fairly present”/“true and fair view”
 - “material misstatements.”
12. Users perceive a lack of information in the report *about the audit* performed for the particular entity, as well as about the audit process and audit findings and the resulting level of assurance obtained in the audit. In the absence of such information, more sophisticated users feel they are unable to assess the level of confidence they can associate with the financial statements based on the audit.

Examples of the types of information users seem to want about the audit for a specific entity are:

- Circumstances or relationships that might bear on the auditor’s independence.
 - Information about “audit materiality,” i.e., levels of materiality applied on the audit to identify known or likely material misstatements in the audited financial statements.
 - The level of assurance actually achieved in the audit.
13. Users would like additional reporting of information *about the entity* by the auditor, within the auditor’s report on the audited financial statements.

User perceptions about auditor reporting in general are shaped also by their expectations linked to the value of auditor communications more broadly, including regarding matters that go beyond the objective of an audit of financial statements.

For example:

- (a) Some users believe that auditors should report on other matters of interest to users such as:
 - The quality of the entity’s financial statements and its financial reporting system (and internal controls).
 - The quality of the client as a business entity.

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- (b) Information the auditor has about an entity as a result of performing the audit, and information discussed with or reported to the audit committee, should be communicated to users as well.
 - (c) Reporting to external parties in public interest situations (e.g., reporting to regulators in certain conditions).
14. The Working Group noted that in some countries national corporate and securities laws extend statutory audit reporting requirements to include additional reporting responsibilities for the auditor in relation to the audited entity. For example, in some countries the auditor is required to report also on whether the entity has kept proper accounts and records in compliance with relevant law or regulation. Ordinarily these reporting responsibilities are sufficiently closely related to the audit work effort for the audit of an entity's financial statements to be able to be reported on pursuant to the audit of the financial statements.
15. In other countries, notably the United States and Japan, an additional reporting role has been established for the statutory auditor to report on matters that go beyond the audit of the entity's financial statements. For example, the Sarbanes-Oxley requirements applicable to issuers of securities registered with the US Securities and Exchange Commission have given rise to the integrated audit and associated reporting responsibilities. Two of the research studies reported that users perceive this type of audit as being more useful than the standard audit in that additional information is provided about the effectiveness of the entity's internal controls related to financial reporting.

Matters for CAG Consideration

16. The Working Group would like to obtain the Representatives' feedback on the questions set out below regarding the Key Messages.

In the light of the general messages reflecting user perceptions (paragraph 9 in this CAG Paper):

- 1) Do Representatives believe the auditor's report needs to have greater communicative value? If yes, how might that be achieved within the auditor's report in view of different, and sometimes conflicting, user preferences regarding format and content of the report?
- 2) Do Representatives believe that the current auditor reporting model for financial statement audits reflected in ISA 700¹ needs to be reconsidered, with the aim of increasing the usefulness of the auditor's report to users?
- 3) Do Representatives consider that inclusion in the auditor's report of language describing the nature of an audit, and about the respective roles of the auditor and the entity's management (or those charged with governance of the entity, as appropriate), might assist in reducing or managing the expectations gap that exists regarding the financial statement audit? Are these

¹ ISA 700, "Forming an Opinion and Reporting on Financial Statements."

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communications important to retain within the auditor's report?

- 4) What other aspects of the current reporting model do Representatives consider are important to retain when considering how the auditor's report, or its form and content, might be changed to enhance the usefulness of the report?
- 5) Do Representatives agree that considerations about increasing the quality (effectiveness) of auditor reporting need to be framed in the wider contexts of auditor communications and also audit quality?

In the light of the specific messages reflecting user perceptions (paragraphs 10-15 in this CAG Paper):

- 1) Do Representatives believe that the auditor's report needs to contain more information about *the audit process* itself, and matters related to the audited financial statements? What information might be considered useful, and how would it assist users?
- 2) Do Representatives believe that the auditor's report needs to contain more information about *the audited entity*? What information might be considered useful, and how would it assist users?

Possible Actions and IAASB Considerations

17. The Working Group has reflected on possible courses of action that may be appropriate to advance consideration of auditor reporting issues going forward. Information relevant to the Working Group's considerations and recommendations to the IAASB is set out in more detail in the CAG Reference Paper IAASB Paper Agenda Item 4-A, Section IV paragraphs 45-52.
18. As an overall consideration, the IAASB recognized that there would be little gain in "tinkering" with the auditor's report in further efforts to fine-tune it. The current report set out in ISA 700 has developed over many years and reflects the accumulated experience of many years of auditor reporting catering to a wide variety of users of audited financial statements.

Understanding User Needs in Relation to Auditor's Reports on Financial Statements

19. The IAASB recognized that information from which the key messages were derived, while useful and informative, would need to be further analyzed. A better understanding is needed about what users need from auditor's reports on financial statements, including information that might be communicated in the auditor's report and the underlying reasons or needs users aim to satisfy.
20. There is a wide variety of users of audited financial statements. They differ between small and large entities, as well as public-interest and non-public interest entities. They include not only investors operating in investment markets and lenders in the credit finance markets, but also regulators who require audited financial statements to meet various regulatory objectives. Among small entities users include owner/managers, grant-funding

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bodies, lenders and suppliers.

21. Entities that are not public-interest entities have a different environment with regard to both communications with auditors and their corporate accountability arrangements. Users in the small entity environment are likely to have differing needs for communication with the auditor and auditor reporting. There may often be greater scope for users to interact and communicate with the entity's auditor than is the case for larger entities. This factor may explain some of the needs surrounding auditor reporting and communications among larger entities and public-interest entities.
22. User needs in relation to auditor reporting will be difficult to reconcile in many respects, or perhaps simply be irreconcilable. Some users would prefer a short-form, "opinion only" style of report. Others express a desire for a long-form report that would contain not only an auditor's opinion on the financial statements, but also other information relevant to the particular audit carried out and other reporting responsibilities (where relevant). Still others would advocate use of a simple "check-mark" approach.
23. The main benefit of having a "single model" for the auditor's report for all users, as currently exists with the ISA 700 model, is that it drives consistency in auditor reporting, and therefore also promotes clarity in auditor reporting. Many believe this significant benefit could be lost if different reporting models are developed in an attempt to meet needs of different users or classes of users. The communication to users in the auditor's report provides needs to be very clear in order to provide useful information.
24. The current reporting model for the financial statement audit is driven by the objective of providing the auditor's opinion about the fair presentation of the financial statements (or whether they provide a "true and fair view"). The model embodies certain implicit cost-benefit considerations regarding achievement of that primary objective.
25. If the objective(s) that drive auditor reporting were to be widened to encompass other matters, for example to include reporting about the entity in addition to reporting on the entity's financial statements, the likely effects and consequences of moving in that direction would need careful prior consideration by all parties who would be affected, not only users. For example, if reporting were developed to include matters about the entity, such reporting would blur the distinction between auditor and management responsibility. Expanding the reporting model also would increase the likelihood that the current financial statement audit would be transformed into a broader assurance engagement. The cost-effectiveness of having the external auditor report on a range of other matters would need careful consideration.
26. Key to developing a fuller understanding of user needs will be to know:
 - What sort of information different users need, and how would having that information reported by the auditor increase the value of the auditor's report?
 - What would the additional information be used for?
 - Whether information desired by users should be provided in the auditor's report, or

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- whether such information can best be provided through alternative forms of communication? Why should an auditor provide the information (rather than some other party, for example management or those charged with governance of the entity)?
- What cost implications would there be, and who would bear those costs? What benefits would be derived and to whom would they accrue?
 - Is the information obtained by the auditor in the course of an audit of financial statements? Or does obtaining the information mean extending the purpose of the audit beyond the financial statement audit?
27. The Working Group believes further targeted consultation or research to shine a light on these questions and, where possible, obtain some answers, would be a useful next step. Use of the focus-group approach may offer the best way to obtain this information canvassing different categories of users. The Working Group would like to understand Representatives' views on how this can best be done.
28. Finally, and importantly, the IAASB recognizes that while having a better understanding of user needs is a necessary step for consideration of further actions, any proposed changes to the auditor's report needs to be considered with reference to the interrelations between audits and systems of financial reporting and corporate governance. These interrelations are fundamental to the interrelationship between auditing, financial reporting and governance.

Understanding Benefits Associated with Different Auditor Reporting Models

29. The Working Group has considered different auditor reporting models used in France, Japan and the United Kingdom. These reporting models are clearly different in some significant respects (for example, in both content and in the way content is communicated to users). In some cases they involve increased audit costs necessary to provide additional information in the report (for example, France).
30. The Working Group believes there would be benefit in understanding whether the different models are viewed as beneficial by users and markets in these countries, and whether they deliver better communicative value for users. Further research studies could possibly provide this information.

Matters for CAG Consideration

31. The Working Group would like to obtain the Representatives' feedback on the questions set out below regarding possible actions and further considerations.

Possible Actions and IAASB Considerations (paragraphs 17-30 in this CAG Paper)

- 1) Do Representatives believe that seeking more information about user needs is essential to proceed to better understand how the auditor's report might have more communicative value for users? How can user views best be obtained, and which main categories of users need to be asked?

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- 2) Do Representatives believe there is need for research to better understand costs and benefits associated with different reporting models, for example reporting models applied in different countries?
- 3) Do Representatives agree with the IAASB's view that corporate governance and financial reporting systems are fundamentally important to a consideration of how to improve the usefulness of the auditor's report? If so, do Representatives believe that a consideration of changes to the current auditor reporting model embodied in ISA 700 should be undertaken with a concurrent evaluation of how corporate governance and financial reporting models respectively contribute to meeting users' information needs?

Material Presented – IAASB CAG REFERENCE PAPERS ONLY

Agenda Item 4-A of the
December 2009 IAASB
Meeting – Auditor's
Reports – IAASB Working
Group Report

<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=5108>

Four IAASB/AICPA
commissioned research
studies on user perceptions
of the standard unqualified
auditor's report

["The Unqualified Auditor's Report: A Study of User Perceptions, Effects on User Decisions and Decision Processes, and Directions for Future Research"](#) (May 2009)

["Report on Research Conducted in the United Kingdom and New Zealand in 2008 Investigating the Audit Expectation-Performance Gap and Users' Understanding Of, and Desired Improvements To, the Audit Report"](#) (September 2009)

["Investors', Auditors' and Lenders' Understanding of the Message Conveyed By the Standard Audit Report"](#) (September 2009)

["Financial Statement Users' Perceptions of the IAASB's ISA 700 Unqualified Auditor's Report in Germany and the Netherlands"](#) (August 2009)

IFAC SMP Committee
Comments on Issues Paper
presented to the IAASB at
its December 2009 meeting

[Word File attached](#)