

**IAASB**<sup>TM</sup>

## Views on the Exposure Draft on Auditor Reporting

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IAASB CAG Meeting – Agenda Item C

March 11-12, 2014

## Overview – Agenda Item C Dan Montgomery, Task Force Chair and DT-701 Chair

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## Breakout of 138 Respondents to Exposure Draft (ED) by Category

Respondent Category	Number	Percentage
Investors and Analysts	12	9%
Those Charged with Governance (TCWG)	1	1%
Regulators and Audit Oversight Bodies	16	12%
National Standard Setters (NSS)	12	9%
Accounting Firms	16	12%
Public Sector Auditors	14	10%
Preparers	9	6%
Member Bodies and Other Professional Organizations	42	30%
Academics	9	6%
Individuals and Others	7	5%
<b>Total</b>	<b>138</b>	<b>100%</b>

*With the exception of TCWG, breakout amongst stakeholder groups broadly consistent with responses to June 2012 ITC (165 total)*

*Pleased to see such continued global interest – noted also through our outreach*

## Overall Views about Auditor Reporting

- Broad support for overall direction of the proposals
- Recognition that inclusion of Key Audit Matters (KAM) for audits of listed entities will be a significant change in practice
- Concerns with some aspects of the proposals, and calls for additional guidance in some areas to support the principles-based requirements
- Encouragement to align various approaches for global consistency, to the extent practicable

## Activities to Support Effective Implementation of the Final Standards

- IAASB urged to consider a “roll-out plan” when the standards are finalized to ensure they are achieving their intended objectives
  - How best to educate investors, preparers and TCWG
  - Implementation support for auditors
  - How this might be done in conjunction with others
- Support for the planned post-implementation review

## Relevant Developments – PCAOB

- August 2013 Proposals
  - Auditor reporting on Critical Audit Matters
  - Required statements about auditor tenure and auditor independence
  - Expanded description of standardized language about the audit and the auditor’s responsibilities
  - Revisions to the standard addressing “other information”
- December 2013 Re-proposals
  - Disclosure of engagement partner name
  - Disclosure of names, locations and extent of participation of others

## Relevant Developments – European Audit Reform Proposals

- Revised audit reform proposals were agreed between the European Parliament and the Lithuanian European Union presidency and approved unanimously by COREPER
  - Regulation applies to audits of public-interest entities (PIEs); Directive applies to all entities
  - Proposals similar to KAM would be required for PIEs
  - Auditor reporting on going concern would be required for all entities
  - Disclosure of the name of the engagement partner is already required under the Eighth Company Law Directive

## Relevant Developments – UK Financial Reporting Council

- Changes became effective for audits of financial statements for periods commencing on or after October 1, 2012
- Auditor reporting complementary to Audit Committee reporting
  - Description of those assessed risks of material misstatement which had the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team
  - Disclosure of materiality threshold for the financial statements as a whole
  - Overview of the scope of the audit, including how assessed risks of material misstatement were addressed

## Drafting Team Structure and Responsibilities for the Auditor Reporting ISAs

*Continuing to be nimble in determining the best way to progress rapidly – Formed new Drafting Team (DT-570) post-exposure; ISA 720 TF addressing other information*

DT-701	DT-700	DT-570
Key Audit Matters	Other Suggested Improvements	Going Concern
<ul style="list-style-type: none"> <li>ISA 701 – KAM</li> <li>ISA 706 – Emphasis of Matter and Other Matter Paragraphs</li> <li>ISA 260 – Communication with TCWG</li> </ul>	<ul style="list-style-type: none"> <li>ISA 700 – Unmodified Reports</li> <li>ISA 705 – Modified Reports</li> <li>ISA 800 Series – Special Purpose Financial Statements or Elements</li> </ul>	<ul style="list-style-type: none"> <li>ISA 570 – GC</li> <li>Liaison with accounting standard setters</li> </ul>

## Planned Discussions at Upcoming Meetings

Meeting	DT-701 – KAM	DT-570 – GC	DT-700 – Other Improvements
March 2014 IAASB and CAG	<ul style="list-style-type: none"> <li>Issues related to determining and communicating KAM</li> </ul>	<ul style="list-style-type: none"> <li>Issues related to reporting on GC</li> </ul>	<ul style="list-style-type: none"> <li>Various issues related to other suggested improvements</li> </ul>
June 2014 IAASB	<ul style="list-style-type: none"> <li>Draft ISA 701</li> <li>Issues related to ISA 260 and ISA 706</li> <li>Illustrative examples</li> </ul>	<ul style="list-style-type: none"> <li>Draft ISA 570</li> </ul>	<ul style="list-style-type: none"> <li>Finalization of ISA 700</li> <li>Issues related to ISA 705</li> <li>Illustrative reports</li> </ul>
September 2014 IAASB and CAG	<ul style="list-style-type: none"> <li>Finalization of all standards and illustrative examples</li> </ul>	<ul style="list-style-type: none"> <li>Finalization of ISA 570</li> </ul>	<ul style="list-style-type: none"> <li>Finalization of ISA 705</li> <li>Exposure draft of ISA 800 series</li> </ul>

## Key Audit Matters – Agenda Item C.1 Dan Montgomery, Task Force Chair and DT-701 Chair

## Objectives of the CAG Discussion

- Determining KAM
  - Obtain input on DT-701's proposed revisions to the requirements to determine KAM, including how the proposed standard should address sensitive matters

## Objectives of the CAG Discussion (cont.)

- Communicating KAM
  - Obtain input on DT-701’s proposed revisions to the requirements to communicate KAM, in light of the mixed views about whether it is appropriate to allow flexibility for the auditor to include information about audit procedures and outcomes

## Overall Views about Key Audit Matters

- Overall support for the inclusion of KAM in the auditor’s report for audits of financial statements of listed entities
  - Will contribute to improving the quality of the audit and financial reporting
  - Provides information that may assist users in understanding the entity and areas of significant management judgment
  - Focuses investors on key issues included in the financial statements
- Minority, in particular preparers, do not support KAM
- Concerns about the auditor being the provider of “original information” or disclosure about “sensitive matters”

## Views on Consistency in Auditor Judgments in Relation to KAM

- Mixed views whether proposed ISA 701 would promote consistency in how auditors determine and communicate KAM
  - Majority generally supported the use of auditor judgment, but calls for greater consistency coming primarily from regulators and oversight authorities
  - Other stakeholders of the view that providing relevant information to users in the description of a KAM is more important than consistency
    - Fear of KAM becoming boilerplate after the first year
  - Many note the IAASB will learn through post-implementation review

## Respondents' Views on Determining KAM

- Strong support for KAM to be based on matters communicated with TCWG
- But focus the determination of KAM on what is most relevant to users – a point noted from firms' field testing
  - Matters that met the IAASB's original "criteria" would not always be relevant to users
- Clarification of the concepts of "significant auditor attention" and matters "of most significance"

## Revision to the Requirement to Determine KAM – DT-701 Rationale – Para. 31 of Agenda Item C.1

- Better articulate the thought process of the auditor to consider the “drivers” of areas of significant auditor attention
- More closely linked to matters likely to be disclosed in the financial statements
  - Revised factors take into account feedback from field testing
  - Factors are considerations, but not “indicators” of KAM – there may be other areas of “significant auditor attention”
- Second “filter” to select the matters “of most significance”

## Respondents’ Views on Determining KAM (cont.)

- Continued concern about the auditor providing “original information” in the auditor’s report
  - Some investors are of the view that the auditor should be freely able to comment on any matter they believe would be of the value to users
  - But others called for greater specificity about how “sensitive” matters should be addressed
  - Reporting certain matters could have unintended market consequences due to lowering of the threshold for disclosure

## Addressing Sensitive information – DT-701 Rationale

- Need for a new requirement to address concerns
  - Communication with TCWG to be required if a KAM relates to a sensitive matter
  - Auditor should carefully consider the facts and circumstances of the entity, the legal environment in which it operates
  - Guidance to outline possible actions (e.g., relating to confidentiality, legal advice, etc.)
- May need to reconsider whether to allow for the possibility that a matter determined to be a KAM should not be communicated

## Respondents' Views on Communicating KAM

- Majority supported flexibility in describing an individual KAM, but calls for more guidance as to when an auditor may judge it necessary to describe “the effect on the audit”
  - Minority (mainly regulators and NSS) looking for strengthened requirement to enhance consistency in what is provided to users
  - Investors and others looking for a description of how the matter was addressed in the audit and the outcome of the audit process
- Overarching theme that the description of a KAM should be relatively clear, concise, understandable and entity-specific

## Revision to the Requirement to Determine KAM – DT-701 Rationale – Para. 62 of Agenda Item C.1

- As the majority of respondents liked the current flexibility, no significant changes made to the requirement
  - “Effect on the audit” replaced by “How the matter was addressed in the audit”
- Instead, concerns to be addressed in application material and potentially changes to the required introductory language in the auditor’s report to emphasize, in particular, that
  - The more entity-specific the description of a KAM, the more useful
  - KAM not intended to be a “piecemeal opinion” or a substitute for a modified opinion

## Going Concern – Agenda Item C.2 Chuck Landes, DT-570 Chair

## Objectives of the CAG Discussion

- Obtain input on the DT's proposal not to go forward with the two statements proposed in the ED in respect of GC and the DT's alternative proposal to revert to exception-based reporting for material uncertainties (MU) identified in respect of GC
- Obtain input on the DT's proposals to include additional wording in all auditor's reports in the Auditor's Responsibilities and Management's Responsibilities sections of the auditor's report about GC

## Overall Views about Going Concern (GC)

- Respondents continue to advocate a holistic approach to addressing GC in financial reporting
  - Mixed views around value and practicality of IAASB's proposals without changes to accounting standards, with some suggesting deferral
  - Concern that auditor statements may be misinterpreted by users if there is a lack of consistent understanding of the underlying accounting concepts
  - IAASB continuing to liaise with IASB to encourage them to take further action
    - IASB decided not to move forward with its GC project in November 2013
    - IFRIC concerned about the IASB's decision not to proceed

## Respondents' Views on Statement about the Appropriateness of the Use of the GC Basis of Accounting

- While some level of support, on balance respondents questioned the value of making explicit something that is implicit in the preparation of the financial statements
  - Generally understood to be a premise on which the financial statements are prepared
  - Limited value and essentially boilerplate language
  - May be seen as providing a different level of assurance on GC

## Respondents' Views on Statement about Whether a MU Had Been Identified

- Many respondents indicated a preference for exception-based reporting (i.e., only when a MU had been identified)
  - Concerns that users could become desensitized to MU reporting, and important messages obscured, if a GC section included in all auditor's reports
  - Singling out GC in a boilerplate fashion does not respond to calls for enhanced and clarified disclosures about GC by management

## Other Concerns about Auditor Reporting on GC

- Need for clarification about whether “close calls” related to GC would be reported as KAM
  - Questions over interaction with any such disclosures and the GC section of the report
  - To be considered further in coordination with DT-701
- Industry concerns, in particular banking and public sector
- Statements in the auditor’s report may imply greater comfort on an entity’s future prospects than is warranted

## DT-570’s Recommendations

- Do not require the two statements proposed in the ED in respect of GC
- Rather, revert to exception-based reporting for MU identified in respect of GC (when an unmodified opinion is appropriate)
- Include additional wording in all auditor’s reports in *Auditor’s Responsibilities* and *Management’s Responsibilities* sections about GC
- Explore the potential for providing additional guidance around “close calls”
  - Interaction with KAM as well as adequacy of disclosures
- Continue to work with accounting standard setters and regulators on a holistic approach

## Rationale for DT-570's Recommendations

- Overarching calls to address issues related to GC on a holistic basis warrants re-consideration of an appropriate way forward
  - ED highlighted the possibility that IAASB's plans would likely be affected by the developments of accounting standard setters
  - Much of the support for the IAASB's proposals was premised on complementary actions by accounting standard setters
  - Concerns need to be weighed against perceived benefits

## Rationale for DT-570's Recommendations (cont.)

- Exception-based reporting appropriately focuses on highlighting when an actual issue related to GC exists
  - Work effort in ISA 570 remains the same, and would be highlighted in the Auditor's Responsibility section
  - Separate section "Material Uncertainty Related to GC", included with reference to where such disclosures are included in the financial statements

## Rationale for DT-570's Recommendations (cont.)

- Enhancing the Management's and Auditor's Responsibilities sections of the auditor's report is a useful way of drawing attention to the auditor's work in relation to GC
  - Replaces the proposed statement on the appropriateness of management's use of the GC basis of accounting
  - Explains the auditor's work in accordance with ISA 570
  - Incorporates wording in the illustrative auditor's report to retain reference to key concepts

## Rationale for DT-570's Recommendations (cont.)

- DT-570 will further consider whether there are opportunities within application material in the ISAs to explain more about the auditor's work to evaluate the adequacy of GC-related disclosures
- Liaison with the IASB and monitoring of the work of others with respect to GC is expected to continue
  - Future activities could be taken into account as part of the post-implementation review, or sooner if necessary

## Other Suggested Improvements – Agenda Item C.3 Bruce Winter, DT-700 Chair

## Objectives of the CAG Discussion

- To provide input on the DT's recommendations and proposed revisions to proposed ISA 700 (Revised), specifically as it relates to:
  - Independence and other ethical requirements, including listing of sources
  - Disclosure of the engagement partner's name for audits of financial statements of listed entities, including the harm's way exemption
  - Enhanced description of the auditor's responsibilities and key features of the audit, including relocation
  - Structure and format of the ISA auditor's report

## Respondents' Views on Independence and Ethical Requirements

- Majority of respondents supported the inclusion of an explicit statement about auditor's independence and other ethical responsibilities
- However, majority of respondents opposed the proposal to list the sources of these requirements
  - Difficult to implement in certain jurisdictions or circumstances
  - Users not familiar with the nuances of the independence and ethics rules to fully appreciate the more complex disclosures that would be necessary

## Independence and Ethical Requirements – Rationale for DT-700's Recommendations – Para. 14 of Agenda Item C.3

- Retaining a statement about independence and ethical requirements responds to calls for greater emphasis in this area
  - Clarification of wording in the illustrative auditor's report needed to address concerns
- There is a need to acknowledge practical challenges of having a requirement to list sources
  - No longer required to be disclosed
  - Application material to be developed to acknowledge that disclosure of sources may be required in local jurisdictions, or, when not required, useful to include when practical to do so

## Respondents' Views on Disclosure of the Engagement Partner's Name

- Majority of respondents supported disclosure of the engagement partner's name (unchanged from ITC)
- Respondents from jurisdictions where disclosure of the name is not required continue to raise concerns
  - Concerns about safety, security and liability
  - Do not agree that disclosure would enhance accountability
- Support for the harm's way exemption but calls to clarify and strengthen it to avoid potential abuse

## Disclosure of the Engagement Partner's Name – Rationale for DT-700's Recommendations – Para. 38 of Agenda Item C.3

- Retained requirement for disclosure of EP in the auditor's report for listed entities
  - Revised requirement to focus on identification of the EP, thereby allowing additional flexibility for law, regulation and NSS to tailor requirements
- Retained text in illustrative auditor's report that includes naming of EP
- Retained requirement for harm's way exemption
  - Proposing to require the auditor to communicate with management and TCWG when invoking this exemption

## Respondents' Views on Enhanced Description of the Auditor's Responsibilities

- Support across all stakeholder groups for having an enhanced standardized description, with some drafting suggestions
- Mixed views on allowing description to be relocated to an appendix or permitting reference to a website
  - Some view the description an integral part of the auditor's report
  - Others believe this flexibility is an appropriate way to deal with concerns about the increased length of the auditor's report

## Enhanced Description of the Auditor's Responsibilities – Rationale for DT-700's Recommendations – Appendix 2 of Agenda Item C.3

- Important to move forward with an enhanced description of auditor's responsibilities and key features of an audit
- Continue to permit relocation to an appendix
  - Further consideration of the need for additional application material
- Useful to retain the option to make reference to a description on a website of appropriate authority where permitted by law, regulation or national auditing standards
  - Recommend repositioning of this requirement within ISA 700

## Respondents' Views on Structure and Format of the Auditor's Report

- General support for the presentation in the IAASB's illustrative auditor's report
- Majority agrees with approach to mandate specific headings but not mandate ordering
- Strong support for having auditor's opinion first
  - Some have suggested this placement should be mandated
- Mixed views on allowing flexibility in placement of "Other Reporting Responsibilities" (ORR)

## Structure and Format of the Auditor's Report – Rationale for DT-700's Recommendations – Para. 67 of Agenda Item C.3

- Useful to mandate placement of the "Opinion" section first followed by the "Basis for Opinion" section
  - Reversed the ordering of the two paragraphs within the "Opinion" section for illustrative purposes, but not required
  - Headings for all other sections will be mandated, but not ordering of these sections
  - Flexibility for alternate presentation due to law, regulation or national auditing standards retained
- Clarify requirements in relation to positioning of ORR



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