

**Meeting:** IAASB  
**Meeting Location:** Edinburgh  
**Meeting Date:** June 11–15, 2012

## Agenda Item 3

### Auditor Reporting—Proposed Invitation to Comment

#### Objective of Agenda Item

1. To approve the proposed draft Invitation to Comment (ITC): *Improving the Auditor's Report*.

#### Task Force (TF) and Subcommittees

2. The TF comprises the following IAASB members:
  - Dan Montgomery, IAASB Deputy Chair, Chair of TF
  - Jon Grant
  - Merran Kelsall
  - Bill Kinney
  - Annette Köhler
  - Bruce Winter
3. The TF is supported by four subcommittees: Clarifications and Transparency; Building Blocks; Auditor Commentary; and Going Concern/Other Information.<sup>1</sup>

#### Activities since Last IAASB Discussion

4. Subsequent to the April 17 and 24, 2012 IAASB teleconference meetings, the TF discussed issues and the proposed improvements to auditor reporting at its annual IAASB-National Auditing Standard Setters (NSS) Liaison meeting.
5. The TF held both physical and teleconference meetings to develop the draft ITC and further revise the draft illustration of a possible improved auditor's report ("draft illustrative auditor's report"), as presented in **Agenda Items 3-A** and **3-B**. The TF's deliberations took into account the input received during the March IAASB Consultative Advisory Group (CAG), the March and April IAASB meetings, and the April IAASB-NSS meeting.

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<sup>1</sup> The subcommittee compositions are (unless otherwise indicated, subcommittee members are IAASB members): *Clarifications and Transparency Subcommittee* – Bill Kinney (Chair); Caithlin Mc Cabe; Abdullah Yusuf; Susan Jones, IAASB Technical Advisor; *Building Blocks Subcommittee* – Merran Kelsall (Chair); Brendan Murtagh; Tomokazu Sekiguchi; Jon Rowden, IAASB Technical Advisor; Len Jui, KPMG Beijing; *Auditor Commentary Subcommittee* – Dan Montgomery (Chair); Cédric Gélard; Marc Pickeur; Marek Grabowski, IAASB Technical Advisor; *Going Concern/Other Information Subcommittee* – Jon Grant (Chair); Arch Archambault; Annette Köhler; Bruce Winter.

6. The TF chair will brief the IAASB on the highlights from the discussions on the project at the IAASB-NSS Liaison meeting. The TF chair also will provide an overview of the matters addressed in this Issues Paper and the draft ITC, as well as considerations for the way forward.

## Matters for IAASB Consideration

7. **Agenda Items 3-A and 3-B** present the proposed ITC developed by the TF. The purpose of the ITC is to solicit feedback on the value and impediments of the IAASB's identified options to improve auditor reporting. In addition to serving as a basis for written public comments, the ITC will also be used prominently in planned IAASB roundtables and other outreach activities. Accordingly, its design features: highlights of main points so that they are easily identifiable; prominent placement of the draft illustrative report; a summary discussion of the IAASB's rationale; and questions tailored to key stakeholders. The intent is to have a document that achieves an appropriate balance between readability and comprehensiveness.
8. The TF has taken care to appropriately characterize the IAASB's discussions to date, and ensure that it is clear that the IAASB's decisions to date are in fact preliminary. That is, while the ITC may indicate proposed actions, this does not preclude the IAASB from reconsidering its position on one or more matters in light of feedback received from the consultation. In general, the ITC does not include specific wording of possible future requirements and guidance, as this will be further considered and will form the basis for the planned 2013 exposure draft.
9. This remainder of this paper discusses matters for which the TF is seeking additional IAASB feedback.

## Auditor Commentary (AC)

### *Refining How AC is Described and Operationalized*

10. Both the TF and the IAASB have generally supported the view that the objective of AC is for the auditor to provide additional information about the audited financial statements or the audit in the auditor's report, and that Emphasis of Matter (EOM) and Other Matter (OM) paragraphs would be consistent with that objective. The IAASB asked the TF to further consider the requirements in extant ISA 706<sup>2</sup> and other relevant ISAs relating to EOM and OM paragraphs to determine how they would best fit into a broader concept of AC. The TF concluded that it was necessary to revisit the approach being taken to AC to ensure the concept, and its objectives, would be made clear in the ITC. The TF is of the view that using the familiar mechanisms of EOM and OM paragraphs, adapted as necessary to meet the objective of AC, is a sensible approach that leverages the existing ISAs, rather than creating a new mechanism for this purpose. See paragraphs 40–67 of **Agenda Item 3-A** for further information.
11. In this regard, the TF concluded the following:
  - The overarching objective of a new AC section in the auditor's report is to provide transparency about matters that are, in the auditor's judgment, likely to be most important to users' understanding of the audited financial statements or the audit.

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<sup>2</sup> ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

- Auditors of public interest entities (PIEs) would be required to include:
    - EOM paragraphs for matters that, in the auditor’s judgment, are most important to users’ understanding of the audited financial statements; and
    - OM paragraphs to highlight “matters of audit significance.” Matters of audit significance would include areas of significant auditor judgment in conducting the audit, which may include, for example, significant risks or areas of higher assessed risks of material misstatement; issues of significance related to the audit scope or strategy; or use of the work of experts or internal audit. It may also include difficult or contentious matters noted during the audit, or other audit matters that would typically be discussed with an engagement quality control reviewer or those charged with governance (TCWG).
  - Introductory language to explain the purpose of, and provide appropriate context to, AC was needed and should be mandated, along with a section heading “Auditor Commentary.”
  - The improvements relating to going concern (GC) and other information (OI) should be classified outside of the scope of AC.
12. The nature of matters that are likely most important to users will differ from entity to entity. Further, mandating certain matters to be discussed in all auditor reports runs counter, in principle, to the notion that such commentary should be tailored to the facts and circumstances of the entity. Accordingly, the ITC explains that the IAASB does not believe that detailed criteria for determining AC should be specified, or that specific matters should be required to be discussed for all entities. It also notes that auditors should be required to consider certain areas as the basis for AC. This approach would allow a degree of commonality while emphasizing the application of professional judgment by the auditor in determining the matters to communicate that are likely to be most important to users’ understanding of the audited financial statements or the audit (see paragraphs 50 and 54 of **Agenda Item 3-A**). The IAASB anticipates developing guidance to help auditors determine which matters to include in AC and the information (at an appropriate level of detail) to provide about those matters in the auditor’s report. Finally, national requirements may also prescribe matters (for example, by specifying areas to be addressed in all auditor’s reports) to be addressed in AC, as well as the specific manner in which they are to be addressed (see **Agenda Item 3-B**). The TF believes it is important to highlight this in the ITC and seek feedback on whether the IAASB’s views are appropriate, as some NSS were of the view that greater prescription about matters to be included in AC could be beneficial.

#### *Illustrative Examples*

13. Four examples of AC have been included in the draft illustrative report. The TF recognizes the challenge of including examples but believes it will be necessary for the IAASB to provide these examples to appropriately illustrate the concept of AC and enable respondents to more fully comment on the value and impediments of the auditor providing this information in the auditor’s report. The ITC explains the TF’s view about the possible number of matters that might be expected in AC for PIEs (see paragraphs 62–63 of **Agenda Item 3-A**).

### Matters for IAASB Consideration

1. Does the IAASB agree with the TF's recommendations relating to AC, including the proposals to expand the use of EOM and OM paragraphs to achieve the broad objective of AC?
2. The IAASB is asked to confirm whether its position that AC should not be mandated for any specific matters remains appropriate, and that paragraph 47 of **Agenda Item 3-A** adequately explains the IAASB's rationale for this position.
3. Does the IAASB agree with the form and content of the illustrative examples for AC and the explicit reference in the ITC to the possible number of matters that may be included in AC?

### Role of Other Auditors

14. Unlike ISAs, auditing standards in the US for both listed and non-listed entities provide group auditors with the option to divide responsibility for the group audit with other auditors, and to make reference to this divided responsibility in the auditor's report. As noted at the March 2011 IAASB meeting, the US Public Company Accounting Oversight Board (PCAOB) has issued a standard-setting proposal that would mandate a disclosure about other auditors involved in the engagement, whether or not the group auditor chooses to divide responsibility. The PCAOB proposal notes that this additional disclosure may improve transparency by providing users with information that enables them to evaluate the other auditors in the same manner that they evaluate the group auditor. For example, users could determine if the other auditors are subject to an audit inspection regime and consider any public inspection reports. It also improves transparency regarding a practice, known as offshoring, whereby certain portions of the audit are performed by offices in a country different than the country where the firm is headquartered.
15. In its previous discussions, the IAASB generally did not support disclosure in regard to the role of other auditors. In particular, there was a view that drawing attention to these other auditors could be seen as dividing responsibility for the audit, and may serve to confuse readers, a concern shared by some of the IAASB CAG representatives.
16. However, in light of the IAASB's focus on improving transparency, the TF believes there is merit in including a standardized description of the auditor's responsibilities in a group audit in the illustrative report. Such a disclosure may assist in improving the transparency of the audit process while avoiding some of the potential drawbacks of specifically identifying other auditors involved in the group audit.
17. The TF notes, however, that an entity-specific disclosure of other auditors involved in the group audit may provide more value to users than a standardized description of the responsibilities of the group auditor, which includes sole responsibility for the opinion on the group financial statements. Accordingly, the TF has drafted a disclosure that could be used, and recommends that the ITC seek respondents' views about the value and potential impediments of requiring disclosures about the role of other auditors, either via standardized material or entity-specific material.
18. The entity-specific disclosure has not been included in the illustrative report as it may be premature to indicate a preferred option until stakeholders' views are known. In particular, there may be

concerns about whether any disclosure of other auditors would be inconsistent with the sole responsibility principle of ISA 600<sup>3</sup> (see paragraph 84 of **Agenda Item 3-A**).

#### *Selection of a Disclosure for the ITC*

19. The TF deliberated what form of disclosure should be included in the ITC to elicit appropriate feedback. Options considered included a version based on the PCAOB proposal, which would list every auditor (Option 1), listing auditors of significant components only (Option 2), and an aggregated disclosure based on a proposal by the US Center for Audit Quality (Option 3). The Appendix to this paper explains the three options in more detail.
20. The TF expressed a preference for using Option 3 for purposes of consultation, as this may present the fewest concerns regarding the ISA 600 prohibition of referring to other auditors, yet contains information that enables users to assess the aggregate role of other auditors. See paragraphs 80–84 of **Agenda Item 3-A** for further information.

#### **Matter for IAASB Consideration**

4. Does the IAASB support the inclusion of a possible disclosure of the role of other auditors in the ITC and, if so, Option 3 as the preferred option?

#### **Responsibilities of Management, TCWG and the Auditor**

21. During the April 24 IAASB teleconference, IAASB members suggested additional descriptions that could be included in the auditor's report to better describe the responsibilities of management, TCWG and the auditor. Matters raised by IAASB members, and the TF's recommendations in relation to them, are as follows:
  - Overall responsibilities of management and TCWG, and the auditor's responsibility to communicate with TCWG. As noted in paragraph 89 of **Agenda Item 3-A**, the TF believes there is merit in describing the role of TCWG and the auditor's communication responsibilities with TCWG in the auditor's report. However, as these responsibilities vary significantly between jurisdictions, the TF believed it would be most appropriate to include in the illustrative auditor's report a limited statement on the responsibilities of TCWG aligned with how ISAs define TCWG, and highlight the expectation that this description, as well as that of management, would be further tailored to best describe the roles of management and TCWG in the context of a particular jurisdiction. A bullet relating to the auditor's responsibility to communicate with TCWG has been included in the Auditor's Responsibility section.
  - References to quality control. The TF debated proposals to include references to firms' quality control requirements in the Auditor's Responsibility section, as a means of complementing the descriptions of how auditing and ethical standards apply in an ISA audit. However, the TF concluded that addressing the responsibilities of the firm or engagement quality control reviewer would contradict the rest of the Auditor's Responsibility section, which addresses only the responsibilities of the auditor and is presented to provide context to the auditor's

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<sup>3</sup> ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

opinion on the financial statements of a specific entity. Accordingly, no standardized language has been included in the illustrative auditor's report.

- Fraud and measurement uncertainty. Some IAASB members expressed concern that language used to better describe the areas of fraud and measurement uncertainty included in the draft illustrative auditor's report previously discussed could be read as defensive. The TF considered, and rejected, the possibility of grouping all such language in one place to describe the inherent limitations of the audit. On balance, while such material may help to narrow the expectations gap by explaining fundamental concepts underpinning the ISAs, the TF concluded that educating users about the limitations with respect to fraud and measurement uncertainty (as well as other inherent limitations of an audit) would be more effective by means other than the auditor's report.

#### **Matter for IAASB Consideration**

5. Does the IAASB support the TF's recommendations above?

#### **Main Changes to the Illustrative Auditor's Report since Last IAASB Discussion**

22. The illustrative report is intended to show the result of the improvements the IAASB has identified that could be made to the auditor's report. The illustration assumes the common scenario of a "clean" (i.e., unmodified) opinion issued on an audit of financial statements in accordance with International Financial Reporting Standards (IFRSs) (i.e., a fair presentation framework). It also assumes the auditor has other reporting responsibilities specified by national law or regulation although these other responsibilities are not specified. The TF concluded that the titles of the financial statements referred to in the Opinion section of the illustrative report are in accordance with IFRSs, in view of the fact that in practice the titles referenced in the auditor's report would be entity-specific to align with the financial statements.
23. The following changes have been made to the illustrative report, included in pages 7–10 of **Agenda Item 3-A**, to reflect comments received from the IAASB, NSS and further deliberations of the TF:
  - GC material now included as a discrete section in the auditor's report, proposed wording of the statement about material uncertainties revised, and description of management's responsibilities for GC tailored to align with IFRSs, with new subheadings to delineate these responsibilities from management's overall responsibility for the financial statements
  - Revision of introductory language in AC section to align with a revised objective and eliminate material considered unnecessary by the TF, and illustrative examples included
  - OI material now included as a discrete section in the auditor's report
  - Title "About Our Audit of the Financial Statement" replaced with "Respective Responsibilities of Management, [Appropriate Title for Those Charged with Governance], and the Auditor
  - New statement about the responsibilities of TCWG added
  - Description of the auditor's responsibilities revised in relation to fraud, evaluating the appropriateness of accounting policies used and the responsibilities of accounting estimates and related disclosures made by management. New description about the auditor's

communications with TCWG added

- Footnotes to explain how material included in the illustrative auditor's report would be tailored in light of the applicable financial reporting framework, or because of law or regulation in a particular jurisdiction, removed and more fully explained in Appendix 5 of the ITC (see **Agenda Item 3-B**), which also describes what elements would be required by the IAASB in an improved auditor's report.

*Other Matters Relating to the Illustrative Auditor's Report Included in the ITC*

24. Having reflected on the results of pilot testing of the building blocks approach by certain NSS, the TF reconsidered its previous recommendation that the IAASB should not mandate ordering based on its preferred presentation in the illustrative auditor's report, noting that ordering within the auditor's report is not currently mandated by ISA 700.<sup>4</sup> The TF was of the view that specifying the order of the elements for auditors' reports across entities and jurisdictions would ensure a report issued for an ISA audit can be easily recognized by investors and more readily compared to reports of other ISA audits. However, the TF also acknowledges that this must be balanced with the need for auditors' reports to be relevant in the context of additional laws of regulations in a particular jurisdiction. On balance, the TF concluded it would be appropriate to mandate ordering of content for all auditors' reports for audits conducted in accordance with ISAs, unless otherwise required by law or regulation. This would serve to reinforce the "IAASB brand" by moving towards a commonly recognized auditor's report, with a longer-term goal of harmonizing the presentation of auditor's reports to the ISA presentation. However, NSS may require particular ordering when the auditor's report refers to the audit being conducted in accordance with national auditing standards.
25. Some IAASB members had expressed the view that there may be merit in including a second illustrative report to contrast how a non-PIE report may be presented, taking into account the ability for certain information to be presented outside of the auditor's report. Having considered an example of this circumstance, the TF concluded that the material in Appendix 5 (**Agenda Item 3-B**) was sufficient for this purpose.

**Matters for IAASB Consideration**

6. Does the IAASB support the changes made to the illustrative auditor's report as described in paragraph 23?
7. Does the IAASB support the TF's recommendation that ordering within the auditor's report be mandated unless otherwise required by law or regulation?
8. Is Appendix 5, included as **Agenda Item 3-B**, useful in illustrating both what would potentially be required by the IAASB as well as what can be tailored using the building blocks approach?

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<sup>4</sup> ISA 700, *Forming an Opinion and Reporting on Financial Statements*

**Material Presented**

- Agenda Item 3-A                      Draft for Discussion—IAASB Invitation to Comment (ITC): *Improving the Auditor’s Report*
- Agenda Item 3-B                      Appendix 5 of the ITC—Applying the IAASB’s Improvements to Auditors’ Reports in National Environments

**Actions Requested**

26. The IAASB is asked to consider the above matters and provide input and guidance to the TF to finalize the ITC in **Agenda Items 3-A** and **3-B**, and to approve the ITC for public consultation.
27. Should IAASB members have editorial changes to the draft ITC, they are asked to share these changes with IAASB Staff in advance of the meeting.

**Appendix**

**Possible Disclosures about the Role of Other Auditors in the Audit**

The following table outlines possible disclosures that could be included in a revised auditor’s report, together with the TF’s view of the perceived value and impediments of each.

Possible Disclosure	Analysis
<p><b>Option 1 – PCAOB proposal (amended and simplified)<sup>5</sup></b></p> <p>Disclose the name, location, and extent of participation in the audit of the other auditors. The extent of participation is measured by the % of the total hours performed by the other auditor in respect of the engagement until the date of the audit report, with a minimum threshold of 3%. A category of “other participants” records the participants who individually comprise less than 3% of the hours performed. Estimates of hours are permitted when final numbers are not available.</p> <p>While not part of the PCAOB proposal, alternative measurements (such as audit fees, or the percentage of assets/revenue covered by the other auditors) could be used in place of audit hours.</p>	<p>Value:</p> <ul style="list-style-type: none"> <li>• Provides users with the identity of the other auditors to enable them to evaluate other auditors in the same manner that they evaluate the group auditor</li> <li>• Disclosure of hours of work for each audit firm allows users to identify where the bulk of the audit engagement was performed</li> </ul> <p>Impediments:</p> <ul style="list-style-type: none"> <li>• Respondents to the PCAOB’s consultation have indicated that this requirement would likely be difficult to operationalize in practice. For example, measuring hours may be difficult when work is performed for a dual purpose (such as another assurance engagement) and may be difficult to measure or estimate given the limited time available</li> <li>• Does not address all offshoring arrangements</li> <li>• Naming other auditors may give rise to liability issues for the named firms in some jurisdictions</li> <li>• Disclosure may be extensive if there are a large number of other firms</li> </ul>

<sup>5</sup> This summary of the PCAOB proposal does not address mechanical aspects of the PCAOB’s proposal, such as precise timing, estimation and ancillary rules.

Possible Disclosure	Analysis
<p><b>Option 2 – Disclose Auditors of Significant Components Only</b></p> <p>Under this option, the disclosure is limited to the names and locations of other firms who are involved in auditing significant components per ISA 600.</p>	<p>Value:</p> <ul style="list-style-type: none"> <li>• Provides users with the most relevant information regarding other firms, but does not obscure this information with disclosures about non-significant components</li> </ul> <p>Impediments:</p> <ul style="list-style-type: none"> <li>• The other firms named in the report will still be subject to the same legal risk as in Option 1</li> <li>• Does not address offshoring</li> </ul>
<p><b>Option 3 – Center for Audit Quality (CAQ) Proposal (edited) [Preferred by TF]</b></p> <p>Include a statement about the firm, the % of the audit done by other firms (tracked by hours, assets, audit fee or some other measure) divided into network firms and non-network firms. For example:</p> <p>We are the auditor of [name of group entity], which is the parent entity of a group of entities (“the group”). We are a member firm of XYZ Partners, a global network of affiliated auditing firms. Each member firm in the network is a separate legal entity, and all member firms follow a common audit methodology and consistent quality control policies. At our request, certain network member firms participated in our audit of the group and covered approximately [percentage of audit, measured by hours, audit fee or asset/revenue]. Other audit firms, not part of our network, also participated in the audit at our request and covered approximately [percentage of audit, measured by hours, audit fee or asset/revenue]. We remain solely responsible for the audit of the group, including the work performed by other auditors at our request.</p>	<p>Value:</p> <ul style="list-style-type: none"> <li>• Avoids the legal issues of Options 1 and 2</li> <li>• Provides users with a sense of the scope of work done by other firms, without the burden of a long list of audit firms</li> </ul> <p>Impediments:</p> <ul style="list-style-type: none"> <li>• Does not enable users to identify the other firms, or enable users to form their own views on the quality of the other firms</li> <li>• Does not address offshoring</li> <li>• Producing the disclosures may be as challenging as if individual firms were disclosed (depending on the measurement criteria selected)</li> </ul>