

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: New York

Meeting Date: March 8–9, 2011

Auditor Reporting—Draft IAASB Consultation Paper

Objective of Agenda Item

1. The objectives of this Agenda Item are:
 - (a) To provide a report back on the Representatives' feedback and suggestions regarding the IAASB's initiatives in the area of auditor reporting as discussed at the March 2010 CAG Meeting, and
 - (b) To obtain the Representatives' views on the draft Consultation Paper (CP), *Enhancing Auditor Reporting and Evolving the Standard Auditor's Report*.

Papers to Be Referred to during Discussion

2. The discussion of this topic will follow the structure of this CAG Paper. Within this paper, reference is made to **Agenda Item M.1**, the draft of the proposed CP, to facilitate the discussion.
3. Hyperlinks are presented at the end of this CAG Paper to the IAASB December 2010 issues paper, which is for reference purposes only.

Project Status and Timeline

4. **The IAASB will be asked to approve a proposed Consultation Paper, the objective of which is to obtain stakeholder views on possible approaches to enhance auditor reporting, at its March 2011 meeting. Accordingly, the draft of the proposed Consultation Paper has been included as Agenda Item M.1.**

5. The Appendix to this paper provides a history of previous discussions with the CAG on this topic, including links to the relevant CAG documentation.

Background

6. The IAASB Auditor Reporting Working Group met in November 2010 to develop the Issues Paper for the IAASB's December 2010 meeting, and on five further occasions in December 2010 through February 2011, to develop the proposed CP for the IAASB's March 2011 meeting. The Working Group held both physical meetings and meetings by teleconference.

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7. Through the contributions of the IAASB Working Group members and consideration of other available information, the Working Group has examined various models of auditor reporting and related experiences of a number of countries that have already taken steps to further enhance auditor reporting, including France, Germany, Japan, the United Kingdom and the United States (US) (for public listed entities) to name a few.
8. A recent survey completed by the Compagnie Nationale des Commissaires aux Comptes (CNCC) to obtain feedback about the perceived usefulness of the auditor reporting model used in France also provided valuable perspectives for the Working Group in development of its approach to the proposed CP.

Discussion held in November 2010

9. In November 2010, the IAASB staff and IAASB Working Group Chairman hosted a discussion with a number of other groups interested in the area of auditor reporting, for the purpose of obtaining an understanding about some of the different initiatives being undertaken in the area of auditor reporting. The meeting was attended by representatives from a number of CAG Member Organizations and observers (specifically, the CFA Institute, International Corporate Governance Network (ICGN), the International Organization of Securities Commissions (IOSCO) and the US Public Company Auditing Oversight Board and also by representatives of the Auditing Standards Board of the American Institute of Certified Public Accountants, the Center for Audit Quality, and the Compagnie Nationale des Commissaires aux Comptes.

IAASB Discussion in December 2010

10. The IAASB Working Group presented an issues paper to the IAASB at its meeting in December 2010.
11. The IAASB considered the Working Group's perspectives presented in the issues paper, as well as the previous discussions with the CAG and the discussions referenced in paragraph 9, and supported the Working Group's recommendation that a public consultation be undertaken, with the aim of releasing a CP in the first half of 2011. The aim of the CP is to explore key issues concerning auditor reporting, in order to obtain stakeholder feedback on possible approaches to enhance auditor reporting. It is intended that the results of this consultation will provide information relevant to the IAASB's consideration of any future standard-setting initiatives to further develop the ISAs addressing auditor reporting in the direction of desired change, for the widest benefit and on an international basis.

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March 1-2, 2010 CAG Discussion

12. Below are extracts from the approved minutes of the March 2010 CAG meeting, and an indication of how the Working Group or IAASB has responded to the Representatives' comments. The IAASB understands that the question of how to accommodate the various needs of the diverse group of users in relation to auditor reporting is a significant challenge. The diversity of users of auditor's reports mirrors the diversity of users of audited financial statements. Accordingly, a number of the Representatives' comments below have been summarized within the draft CP (**Agenda Item M.1**). Given the acknowledged need to consult widely across the broad range of stakeholders, neither the Working Group nor the IAASB has concluded on many of these views, but intends to further consider these views in the context of responses to the CP.

Representatives' Comments	Working Group/IAASB Response
<i>User Perspectives on Auditor Reporting</i>	
Mr. Damant explained the different perspectives of the financial and investment analyst users, who are predominantly focused on the determination of entity valuations, and investor users who have more focus on evaluating matters of corporate governance and compliance.	Point taken into account. The draft CP acknowledges the evidence of an information gap and highlights concerns of users, particularly investors. See paragraphs 29–33 of Agenda Item M.1.
Mr. Hallqvist commented that from the ICGN's perspective the owners of the entity are the users of the audited financial statements. They also pay for the audit. He expressed the view that the auditor's report lacks focus because it is aimed at users more broadly: there are many different types of users of auditors' reports and the result is that the standard report cannot address their needs in a focused way. He conveyed preference for more focused style of auditor's report focused on the needs of the entity's owners as the key users.	Point taken into account. The Working Group's prior discussions highlighted that a key advantage of the current auditor's report is that it embodies a comparable approach to auditor reporting regardless of types of users and their particular needs – it is thought that the benefit of promoting international consistency in auditor reporting has significant advantages, most particularly that users of audited financial statements are able to read auditors reports prepared on a comparable basis throughout the world. Nevertheless, the draft CP acknowledges that the views about the usefulness of the current standard auditor's report (SAR) tend to be different among the different user and stakeholder groups and aims to obtain views from a broad cross-section of different types of users, which would include owners.

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	<i>See paragraphs 6–9 of Agenda Item M.1 and paragraphs 22–29 of CAG Reference Paper.</i>
<p>Mr. Koktvedgaard explained that what is needed is for the auditor reporting model to develop more of a focus on who the relevant users of report are. He noted that in the accounting standards model there is extensive attention and explanation about types of users who are viewed as primary users of financial statements and other users. The benefit of this approach is that the report can be developed with greater focus on responding to needs of primary users of the auditor's report.</p>	<p>Point taken into account.</p> <p>The draft CP acknowledges that the views about the usefulness of the current standard auditor's report (SAR) tend to be different among the different user and stakeholder groups and aims to obtain views from a broad cross-section of different types of users, which would include owners.</p> <p style="background-color: yellow;"><i>See paragraphs 6–9 of Agenda Item M.1.</i></p>
<p>Mr. Morris drew attention to the different environment of public and private entities, noting that many of the comments made were appropriate for public entities. However, with private entities, users' information disclosure and auditor reporting needs are different, and when consideration is being given to the need for more information in the auditor's report the public/private distinction needs to be borne in mind. For example, is a separate type of audit opinion needed when the only type of user will be the entity's owner(s)? For preparers, the cost of reporting as a public entity is great, and preparers would not themselves opt for more extensive reporting. Entities that choose to operate as private entities have the benefit of reduced mandatory information disclosures, and auditor reporting in the private entity environment needs to be reflective of that user environment.</p>	<p>Point noted.</p> <p>The IAASB notes the suggestion that the auditor's report might be further evolved along the lines of a public/private entity distinction – to recognize that with private entities, and also smaller entities, users' information disclosure and auditor reporting needs are different. If pursued this would be a significant development in auditor reporting that would require careful consideration.</p>
<p>Mr. Attolini noted on behalf of the IFAC SMP Committee how strongly the views expressed by representatives reflected the perspectives of large entities that operate in regulated financial markets. He emphasized the relative importance and collective economic contributions of small and medium entities in the economies of most countries. He agreed with the point made by Mr. Morris that the more emphasis is placed on information disclosure and reporting thereon, the more complex and costly financial reporting becomes. Smaller entities do not need this, and in considering the need to provide of additional disclosures</p>	<p>Point taken into account.</p> <p>The draft CP acknowledges the perspectives for audits of smaller entities and notes the IAASB will seek views from users of audited financial statements of smaller entities, for example through representative bodies of SMEs and of their auditors. <i>See paragraphs 17–19 of Agenda Item M.1.</i></p>

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<p>and reporting (by the entity or by the auditor), it should be borne in mind that only entities that really can use the additional information and reporting should be required to provide it.</p>	
<p><i>Role of the Auditor and Expectations Gap Issues</i></p>	
<p>Mr. Koktvedgaard commented on behalf of the CAG Working Group on auditor reporting. He acknowledged that the debate on auditor reporting and auditor communications is very broad. Questions being raised in the context of auditor communications more broadly also point to the need to reflect on accounting frameworks, and whether some “expectations gap” issues are best addressed through changes to accounting frameworks.</p>	<p>Points taken into account.</p> <p>The IAASB recognizes that expectation gap and perception gap issues pervade contemporary debates on the role of the auditor and auditor reporting, as has also been the case in the past. Users’ expectations of the financial statement audit continue to exceed the scope of the audit as defined. The IAASB is continuing its ongoing efforts to bridge the expectation gap, including through its standard-setting and related communications effort.</p>
<p>Mr. Upton commented that the problem of promoting understanding of what the auditor does, and what the auditor does not do in the audit of financial statements is not a new problem, and that perhaps the solution is a strategy of ongoing communication about the financial statement audit – where that communication also being done outside of the auditor’s report. Ms. Blomme noted that there are many ongoing expectation gap issues that need to be addressed. For example, in relation to increasing demands for information about entities from investors and other users, the auditor should not be expected to step into the shoes of the entity and start reporting on things the entity should be reporting.</p>	<p>A fundamental aspect of the expectation gap, key to this debate on auditor reporting, is that under the established model of corporate reporting established under most national law and regulation the auditor should not usually be the originator of the information about the entity. This is important for the effectiveness of the independent audit. Accordingly, information that is, or that needs to be conveyed to users in the corporate reporting model is communicated either by management or by those charged with governance of the entity (e.g. the entity’s audit committee).</p> <p>However, there is an apparent “information gap” between what users need and what they get through the existing corporate reporting model. The draft CP explores possible ways in which the information gap could be bridged.</p> <p><i>See paragraphs 34–65 of Agenda Item M.1.</i></p>
<p>Mr. Cassel also expressed caution about moving too quickly towards considering how to extend auditor reporting to provide more information. Consideration of</p>	<p>Point accepted.</p> <p>The draft CP notes that changes would need to be carefully considered in light of relevant cost-</p>

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<p>the need for greater transparency in sharing relevant information with users' needs to be done while also paying attention to the environment of the legal infrastructure surrounding information disclosure, particularly as it relates to issuers, and public entities vs. private entities. Auditors will need guidance about how they may be able to provide more information, or enhance the communicative value of their reports, without breaching legal principles and requirements.</p>	<p>benefit considerations, and an evaluation of other implications and foreseeable consequences. This should include consideration of legal, regulatory or practical challenges associated with proposed changes, as well as safe harbors for management, those charged with governance, or independent auditors where needed to facilitate envisaged changes.</p> <p><i>See the Preface on page 3 of Agenda Item M.1.</i></p>
<p>Mr. Pickeur emphasized the need to maintain a proper balance in auditor communication, also with regulators, and auditor reporting.</p>	<p>Point accepted.</p> <p>The draft CP acknowledges the interest of regulators in this area. In addition, the interaction between auditor communication and regulators is also being considered in the context of the IAASB's initiative on audit quality (AQ). <i>See paragraphs 12–13 of Agenda Item M.1, and the AQ publication in Agenda Item F.1.</i></p>
<p><i>Users' Information Needs Relating to Auditor Reporting</i></p>	
<p>Mr. Roussey explained the auditor is in a new world, and auditor assurance on the level of reliability of the financial information contained within the financial statements – particularly financial statement risks – needs to take account of user preferences to be able to read the auditor's report with regard to the risks facing a company. He expressed the view that perhaps risks reflected in financial statement need to be addressed in the same way as going concern issues are addressed by auditors. The auditor needs to take a look at the large risks in the financial statements, and possibly there may be scope for including a fourth paragraph in the auditor's report that just focuses on addressing and reporting on those risks. Mr. Koster agreed.</p> <p>Mr. Waldron noted that auditor's reports are also about investor confidence, and commented that for enhanced usefulness auditors' reports need to have greater</p>	<p>Points taken into account.</p> <p>The draft CP explores the further evolution of both corporate reporting models and the auditor reporting model, concurrently and on an international basis to respond to requests for auditor commentary on matters significant to users' understanding of the audited financial statements, or of the audit. <i>See paragraphs 49–65 and 92–117 of Agenda Item M.1.</i></p>

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<p>communicative value, for example in relation to risk, judgments, and materiality.</p> <p>Mr. Krantz noted that the auditor reporting model needs to be able to better reflect the existence of the uncertainties that exist in financial information and related disclosures, and expressed support for the auditor reporting model used in France. He expressed the view that what is missing in the auditor's report are: information about judgments of the auditor; and a more coherent response to all kinds of constituencies. He noted that the current situation in relation to auditor reporting is not good for confidence.</p> <p>Mr. Hallqvist explained that more focused style of auditor's report focused on the needs of owners as users should simply address the following key areas: whether the financial statements adequately describe the company and whether the report is qualified; whether there have been significant frauds; and whether the control environment is adequate.</p> <p>Mr. Pickeur noted, on the subject of financial information disclosures, which are increasing important in the context of financial statement note disclosures, that financial statement disclosures are sometimes written by lawyers instead of accountants, and increasingly these disclosures are becoming quite complex. Auditors should look into the disclosures and perhaps what might be open for discussion is better use of emphasis of matter paragraphs in the auditor's report. Consideration of legal issues is also very important, and it is very difficult for an auditor to put into a report something that his colleague is not putting into the report. Auditors need legal protection to be able to extend the content of auditors' reports. Mr. Johnson agreed that the increasing complexity of information disclosures in financial statements means that often users do not read the note disclosures.</p> <p>Mr. Kuramochi noted that the auditor needs to communicate with investors more clearly, including giving an explanation of what audit is and what process is followed in the audit to build their understanding.</p>	

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<p>Ms. Sucher expressed the view that there is risk in moving too quickly to try to change the auditor's report. What is important is to stand back and consider what is new in the current environment. Certainly the current approach to reporting accounting estimates is very new and different from financial reporting in earlier times, and for these the pass/fail model of auditor reporting currently may not be sufficient. Mr. Gutterman agreed.</p>	<p>Point accepted.</p> <p>The draft CP notes that changes would need to be carefully considered in light of relevant cost-benefit considerations, and an evaluation of other implications and foreseeable consequences. This should include consideration of legal, regulatory or practical challenges associated with proposed changes, as well as safe harbors for management, those charged with governance, or independent auditors where needed to facilitate envisaged changes.</p> <p>See the Preface on page 3 of Agenda Item M.1.</p>
<p><i>Improving the Communicative Style of the Standard Auditor's Report</i></p>	
<p>Mr. Koktvedgaard noted that there are strong perceptions that the auditor's report says more about what the auditor did not or could not do than what the auditor did accomplish – it is full of reservations. He believes the report should have a more positive tone, focusing on what he auditor accomplished in the audit performed, and more disclosure, with consideration of the cost thereof.</p>	<p>Point taken into account. See paragraphs 74–91 of Agenda Item M.1.</p>
<p>Mr. Waldron noted that boilerplate content in the auditor's report is not read and does not provide useful information to enhance the credibility of financial reports. Mr. Krantz agreed.</p>	<p>Point taken into account, this is acknowledged in paragraph 78 of the CP in the context of possible changes to the structure, format and content of the SAR. See Section III. C. of Agenda Item M.1.</p>

Matters for CAG Consideration

13. In line with its recommendation to the IAASB in December 2010, the Working Group has developed the draft CP shown in **Agenda Item M.1.**
14. The IAASB Working Group requests Representatives' views on the matters outlined below regarding the approach developed for the consultation on auditor reporting, as reflected in the draft CP.

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Overview of the Approach Developed by the IAASB Working Group for the Consultation on Auditor Reporting

15. Based on the Working Group’s analysis of information on the subject of auditor reporting, (including information available from recent initiatives undertaken by various organizations represented on the CAG), there are a number of possible areas to explore that hold the prospect of enhancing the relevance and usefulness of auditor reporting for users, and improving the communicative value of the standard auditor’s report. These are the focus of the draft CP.
16. A key premise of the main elements of the CP is that the current scope of the financial statement audit will remain unchanged.
17. The approach allows exploration of possible ways to enhance auditor reporting on an expedited basis. The CP identifies areas where there may possibly be opportunity in the nearer term to address some of the concerns expressed by users of audited financial statements about the relevance and usefulness auditor reporting, including those noted in prior CAG discussions (highlighted in paragraph 12 above).
18. The draft CP also explains how, taken together, an enhanced auditor reporting model along the lines described, and a longer-term initiative to develop an enhanced model of corporate governance reporting (for example through the entity’s audit committee), could bridge the perceived “information gap”¹ that users have pointed to in recent discussions and debates on the subject of auditor reporting, and also could help to increase the value and relevance of the financial statement audit.
19. The Working Group has aimed to present the issues in the proposed CP in a balanced manner, with the intention that the consultation will provide information and feedback to further the IAASB’s understanding of the relative advantages and drawbacks associated with each of the areas identified in the paper. This will assist the IAASB in its consideration of any further standard-setting initiatives in the area of auditor reporting.
20. The Working Group believes that the format and content of the attached CP provides an appropriate basis for the consultation with stakeholders.

Questions for the CAG Representatives

1. Do Representatives agree with the focus of the draft CP? Is this focus appropriate in view of available information pointing to the existence of an “information gap” for financial statement users?
2. While Representatives are invited to comment on any aspect of the CP, views on the following would be particularly helpful to progress the draft:

¹ Users, particularly investors, point to the existence of an information gap between what they need, and believe is available, including information provided by the auditor through the report on the financial statement audit, and information presented in the audited financial statements. (See Section II of Agenda Item M.1.)

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- Whether the draft CP conveys an appropriately balanced tone in relation to the matters discussed;
 - Whether the consultation questions (summarized in **Appendix 3 of Agenda Item M.1**) are appropriate, and whether they will encourage the feedback and information desired for the areas discussed; and
 - Whether the illustrations presented in **Appendix 1 of Agenda Item M.1** are a helpful reference for readers of the draft CP.
3. Representatives are also invited to highlight any further avenues to explore in the area of enhancing auditor reporting, and for improving the relevance and usefulness of the standard auditor's report, that are not reflected in the draft CP.
21. The IAASB will be asked to approve the draft CP at its March 2011 meeting and, if approved, intends to issue it for comment until August 1, 2011. In addition to sharing views during this session via their Representatives, CAG Member Organizations (MOs) are strongly encouraged to submit formal responses to the CP when it is issued.

Material Presented—IAASB CAG PAPER

Agenda Item M.1 Draft Consultation Paper—*Enhancing Auditor Reporting and Evolving the Standard Auditor's Report*

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Appendix

Project History

Project: Auditor Reporting

Summary

	CAG Meeting	IAASB Meeting
Report of IAASB Working Group – key findings from academic research studies on user perceptions of the standard auditor’s report	March 2010	December 2009
Issues Paper and IAASB Working Group Proposals	-	December 2010
Development of Proposed Consultation Paper	March 2011	March 2011
Consultation – planned for March 2011		

CAG Discussions: Detailed References

Report of IAASB Working Group – key findings from academic research studies on user perceptions of the standard auditor’s report	<p><u>March 2010</u></p> <p>See IAASB CAG meeting material: http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=5253</p> <p>See CAG meeting minutes (in Agenda Item D of the following material): http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=5882</p> <p>See report back on March 2010 CAG meeting in paragraph 12 of this CAG paper.</p>
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