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JICPA Comments on the Consultation Paper

Enhancing the Value of Auditor Reporting: Exploring Options for Change

The Japanese Institute of Certified Public Accountants (“we”, “our” and “JICPA”) is grateful for the opportunity to comment on the IAASB’s Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change (CP)*. We provide below our comments on questions in the CP.

Questions

1. Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?
2. If respondents believe changes in auditor reporting are needed, what are the most critical issues to be addressed to narrow the information gap perceived by users or to improve the communicative value of auditor reporting? Which classes of users are, in the view of respondents, most affected by these issues? Are there any classes of users that respondents believe are unaffected by these issues?
3. Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities?

(Comments on Questions 1 and 2)

- The CP explains recent discussions, particularly those which have occurred after the financial crisis. These suggest that because of the existence of the information gap, some stakeholders,

such as investors, wish to obtain more information from the auditor's report. While we recognized such movement to be global; no major debate on the subject has developed to date in Japan. We have recently implemented the format of the auditor's report that is based on the clarified ISAs, and the reaction from users regarding new explanations of management and auditor responsibilities in the auditor's report is not clear at this stage. That being said, we agree the issue of expectations/information gap is ongoing, and the audit needs to continue to develop with the financial reporting evolution in order to maintain and enhance its relevance and quality.

- We believe that a possible approach to address the evolving needs for financial reporting and financial statements audit should be considered within the current division of responsibility between the entity and its independent auditor: this should be the major premise of the consideration. The approach beyond the current division of responsibility would lead to an unnecessary disruption to the whole financial reporting process. Also, we are very concerned that such an approach may result in increasing the expectation gap regarding the nature of the financial statement audit. In addition, depending on the need for change to the auditor reporting, as explained in CP, we believe that just changing the content of the auditor's report within the current scope of the financial statement audit may not be sufficient in order to effectively respond to such need.
- In order to meaningfully narrow the information gap in the longer term, while maintaining the quality of the financial statement audit, we believe that it is crucial for the issue to be considered in a more holistic manner: what information is needed by a wide range of general users, how to provide such information by the entity, and how to provide assurance or other service by the independent auditor on that information. (For more details, please see below our comments starting from question 4)

(Comment on Question 3)

- We believe that whether changes are needed for audits of all types of entities depends on the nature of the change. For example, to ensure consistency between reports, simply changing the general format or content of the auditor's report should be required for audit of all types of entities. On the other hand, we believe other changes may not be necessarily needed for audits of all types of entities, since information needs vary depending on the size of the entity as well as the type of the users. Since the financial reporting in unlisted smaller entities is relatively straightforward and there are only limited users, users' needs for unlisted smaller entities may be different from large or listed entities, and therefore, changes similar for large or listed entities may not be necessary for unlisted smaller ones.
- At the same time, since the types of entities for which the change is needed vary depending on

respective circumstances in each jurisdiction, we believe it is not possible to establish specific criteria that apply globally for determination of the scope of application for the change. Therefore, the change should be incorporated in the standards in a way that each jurisdiction is able to determine the scope of application in response to respective circumstances (for example, by developing requirements that only apply to public interest entities).

Questions

4. Respondents are asked for their reactions to the options for change regarding the format and structure of the standard auditor's report described in Part A. Do respondents have comments about how the options might be reflected in the standard auditor's report in the way outlined in Appendix 1 of this Consultation Paper?
5. If the paragraphs in the current standard auditor's report dealing with management and the auditor's responsibilities were removed or re-positioned, might that have the unintended consequence of widening the expectations gap? Do respondents have a view regarding whether the content of these paragraphs should be expanded?

(Comment on Question 4)

We provide below our comments on options stated in Part A.

Explanations of Management and Auditor Responsibilities/Use of Technical Language

- In order to narrow the expectation gap, inclusion of more explanations of management and auditor responsibilities, or technical words, in the auditor report may be useful. However, if the auditor's report becomes too long, the readability of the auditor report would be compromised. Also, if explanations of management and auditor responsibilities are included in a separate document or as an appendix to the auditor's report, there is a risk that the user may only read the auditor's report.
- From the auditor's viewpoint, the purposes of the inclusion of explanations about management and auditor responsibilities in the auditor's report are (in addition to narrowing the expectation gap perceived by users), to explicitly state the scope of respective responsibilities in the auditor's report. Therefore, inclusion of a brief description in the auditor's report is necessary, and it is beneficial if such description is based on the terminology and explanations used in the auditing standards. On the other hand, if there is a necessity to explain, in detail, the meaning of the financial statement audit (including the management and auditor responsibilities in order to narrow the expectation gap perceived by users), we believe that such communication should be dealt with through other vehicle, such as an educational document that generally explains the meaning of the audit, rather than through the auditor's report.
- As mentioned in paragraph 42 in CP, we believe it is not appropriate to assume that readers are sufficiently well-informed about the responsibilities of management and auditor that are

precondition on the conduct of the audit. Therefore, if “opinion-only” report approach would be adopted, there would be no explanation currently included in the auditor’s report. This may lead to a misunderstanding as to the change of the nature of the audit.

Location of the Auditor’s Opinion

- We believe the location of the auditor’s opinion should not be changed. If the auditor’s opinion is presented in the first paragraph of the auditor’s report, it may result in a situation that users would not read the auditor’s opinion with important information that is prerequisite on the audit, and result in a further expansion of the expectation gap.

(Comment on Question 5)

- Please see our comment on Question 4 above.

Questions

6. Respondents are asked for their reactions to the possibility that the standard auditor’s report could include a statement about the auditor’s responsibilities regarding other information in documents containing audited financial statements. Do respondents believe that such a change would be of benefit to users?
7. If yes, what form should that statement take? Is it sufficient for the auditor to describe the auditor’s responsibilities for other information in documents containing audited financial statements? Should there be an explicit statement as to whether the auditor has anything to report with respect to the other information?

(Comment on Question 6)

- We believe that it may be of benefit to users to include a statement in the standard auditor’s report about the auditor’s responsibilities regarding other information in documents contained in the audited financial statements. As stated in paragraph 53, users are attaching greater importance to other information. By including explanations regarding the auditor’s responsibilities relating to other information, the transparency of the audit process would be enhanced, and that may result in narrowing the expectation gap. On the other hand, if there is ambiguity about the scope of other information (i.e. the scope of ISA 720 is not clear), or if the statement leads to a possible misunderstanding that the auditor provides some kind of assurance on other information, there is risk for the expectation gap to expand further. Therefore, we believe careful consideration is necessary in developing appropriate statement in order to avoid such consequences.

(Comment on Question 7)

- We do not believe there should be an explicit statement as to whether the auditor has anything to report with respect to other information. The auditor’s responsibility in the financial statement audit in accordance with ISAs is to express an opinion on the financial statements. If the auditor reports on other information, that is not within the scope of the auditor’s opinion, there is risk that the auditor’s primary purpose (i.e. to express an opinion on the financial statements) becomes ambiguous, and users may misunderstand that the auditor is providing some kind of assurance on other information. Therefore, we believe it is not appropriate in ISAs to require expression of a conclusion on other information, except in cases when the auditor has additional responsibility specifically required by laws or regulations in a particular jurisdiction.

Questions

8. Respondents are asked for their views regarding the auditor providing additional information about the audit in the auditor’s report on the financial statements.
9. Respondents are asked for their reactions to the example of use of “justification of assessments” in France, as a way to provide additional auditor commentary.
10. Respondents are asked for their reactions to the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor’s report.

(Comment on Question 8)

- We understand the option to provide additional information about the audit, such as stated in paragraph 62, in the auditor’s report on the financial statements, is to enhance transparency of the audit process, and to provide a view into the entity or its financial statements through the auditor’s eye.
- However, we do not agree with this position, since providing only selected information relevant to certain aspects of the audit would not lead to an enhancement of the users’ understanding regarding the audit process. An audit of financial statements is a cumulative and iterative process, and performance of the audit procedure is always accompanied with successive professional skepticism as well as exercise of professional judgment. It is not practicable to provide all relevant information, including the background in which the specific audit procedure is performed, by means of an auditor’s report. Also, even if one would select part of information that is relevant to specific aspects of an audit, and provide such information in a piecemeal manner, users would not be able to truly understand the basis on which the auditor performed certain audit procedures and the relevant context related to the judgment. We are concerned that such an approach would lead to user’s misunderstanding and, moreover, undermine audit effectiveness.
- For example, the determination of materiality threshold is based on the exercise of professional judgment, and the audit methodology in each firm. Therefore, amounts determined by the

auditors may be different between audit firms as well as audit teams, even if the audits were to be performed on the same financial statements. However, by disclosing the materiality threshold, users may misunderstand that the audit quality varies depending on selected materiality levels.

- In addition, we are concerned with the following possible consequences:

- *The effect on communication between the auditor, management and those charged with governance*

The lists provided in paragraph 62 include information that is being currently communicated by the auditor to management or those charged with governance. Therefore, some may suggest that communication of such information to parties outside the entity is relatively easy for the auditor, since additional work effort is not necessary. However, such information is currently being provided in a two-way communication during the course of the financial statement audit. By providing such information outside the entity, open communication between an auditor, management and those charged with governance would be impaired; and there is a possibility that it would undermine the audit quality.

- *The effect by necessity of additional work effort and resources*

Even if information has been already provided to management or those charged with governance, in order to provide such information to parties outside the entity, we envisage additional work effort would be necessary, such as discussion with management regarding the content of the auditor's report and inspection of additional relevant documents. This would affect timeliness of financial reporting. Also, there is a possibility that management may resist for the auditor to perform additional work, which would adversely affect the quality of the financial statement audit itself.

- *The effect by disclosing the audit process and auditor's judgment*

From the perspective of avoiding fraudulent financial reporting, we believe it is not appropriate to provide information about detailed audit processes, including the auditor's thought process leading to judgment on the engagement. By disclosing such information in more detail, the management would be able to predict audit procedures, which would undermine audit quality. On the other hand, providing only standardized information would result in such communication becoming less meaningful.

- *The issue caused by "dueling" information*

As stated in paragraph 64, it is difficult to separate additional disclosure by auditors in the context of an audit from disclosure of additional information about the entity itself. If different information were to be provided from two sources, it would lead to confusion for readers.

(Comment on Question 9)

- We understand the auditor's "Justification of Assessments" in France is a model where the auditor is required to identify certain key areas of the financial statements by referencing these to relevant parts in the financial statements, and to provide information about the audit procedures in those areas, but not to provide new information regarding the entity. We see the primary benefit of this model, by emphasizing the significant matters in the financial statements through the auditor's report, as an aid for users in reading the financial statements that are becoming more complex. However, we believe management should have the primary role to determine which parts in the financial statements are of significance to users, in the context of the applicable financial reporting framework and from the viewpoint of users, and to disclose such information in the financial statements in the first place.

(Comment on Question 10)

- We do not agree with the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor's report. This is because not only it would undermine the independence of the auditor as it is beyond current division of responsibilities between the entity and its independent auditor, but also, we believe, it would adversely affect the quality of the audit as well as of financial reporting. The auditor should not become the original provider of the information about the entity.
- Firstly, considering the suggestions that the terminology in the current auditor's report is difficult to understand, we are very concerned that additional information regarding auditor's views would not be adequately understood by users as intended. We anticipate information listed in paragraph 72 would be provided by explaining relevant auditor's judgment in a qualitative manner. However, as stated in our comment on Question 8, if one would select part of information that is relevant to specific aspects of the audit, and provide such information in a piecemeal manner, users would not be able to truly understand the basis on which the auditor performed certain audit procedures and relevant context related to the judgment. We anticipate this would lead to users' misunderstanding. Also, we are concerned there is possibility of raising questions regarding the relationship of such additional information to the opinion on the financial statement audit. In order to avoid these consequences, we envisage auditing standards to require inclusion of detailed guidance corresponding to different circumstances. However, we expect this would create a dilemma such that more detailed guidance is provided; more information would be standardized, with resulting lower benefits. In addition, we anticipate the content of the information is necessarily driven by the auditor's judgment, however, we are concerned it would cause an additional expectation gap regarding the status attached to such information.

- Secondly, by shifting away from the merit of current auditor reporting style, it may result in adverse effect on quality of audit as well as financial reporting. We believe current pass/fail model (i.e. whether the opinion is unmodified) has great value, since current reporting style works as a mechanism to enhance the quality of the financial reporting through a process toward the auditor expressing unmodified auditor's opinion. Before expressing auditor's opinion, the auditor has various discussions with management and those charged with governance. Through open and constructive communication, and ultimately, by expressing unmodified opinion, the current system contributes to the enhancement of quality of the financial reporting. Such open communication is based on the fact that except for the auditor's opinion, the auditor would not provide information about the entity to third parties. If the auditor provides additional information that is not disclosed by the entity itself to users, such open communication would be compromised, and we are concerned it would end up undermining the audit quality as well as quality of the financial reporting.
- Thirdly, as additional time and resources would be necessary for the auditor to discuss with management additional content of the auditor's report, timeliness of the financial reporting may be adversely affected. Moreover, by focusing time and resources on additional work, there is also a possibility that it would adversely affect the quality of financial statement audit itself.
- Finally, if different information were provided from two sources, it would lead to confusion for readers.
- As stated above, in order to meaningfully narrow the information gap in the longer term, we believe it is crucial that the issue be considered in a more holistic manner: what information is needed by wide range of general users, how to provide such information by the entity, and how to provide assurance or other service by the independent auditor on that information. We believe that such an approach would eventually narrow the information gap, while maintaining the quality of the financial statement audit.

Questions

11. Respondents are asked for their reactions to the options for change relating to an enhanced model of corporate governance reporting, as described in Section III, Part D.
12. To the extent that respondents support this model, what challenges may be faced in promoting its acceptance? Also, what actions may be necessary to influence acceptance or adoption of this model, for example, by those responsible for regulating the financial reporting process?
13. Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?

(Comments on Questions 11 and 12)

- We agree that in order to improve the quality and transparency of financial reporting, including

the audit, enhancement of corporate governance is important. However, corporate governance structures vary between jurisdictions with different legislation and cultures. To explore the proposed model, various actions, such as revision of the relative regulations would be necessary, which are beyond the development of the standards by IAASB. We envisage such actions to consume a lot of time and effort. Also, since performance of additional procedures and resources for such procedures would be necessary, there is a possibility it would adversely affect the timeliness of the financial reporting as well as the quality of the financial statement audit itself. Therefore, we have doubts that implementation of proposed model would have benefits that outweigh the necessary cost. We believe that, in order to enhance the value of the auditor reporting, other options would be more effective for IAASB.

(Comment on Question 13)

- We have doubts that assurance by the auditor on a report issued by those charged with governance would be appropriate. In the proposed model, the external auditor would provide to external users assurance on the report prepared by those charged with governance, and the report would include information that the external auditor originally communicated to those charged with governance. We are concerned that objectivities of the external auditor would be compromised under such model, and the approach does not align with the concept of an assurance engagement. This is because assurance would be provided on a report prepared by those charged with governance. But those charged with governance have a role for oversight of the process of external audit, and subject matter information included in the report issued by those charged with governance would contain information regarding external audit.

Questions

14. Respondents are asked for their reactions to the need for, or potential value of, assurance or related services on the type of information discussed in Section III, Part E.
15. What actions are necessary to influence further development of such assurance or related services?

(Comment on Question 14)

- We believe there is potential value of assurance or related services on information not within the current scope of the financial statement audit. The business environment and financial reporting are becoming more complex, and the potential need for information outside the financial statements (i.e. rather than historical financial information) is increasing. Therefore, we believe the need for assurance on such information would also increase.
- Development regarding information not within the current scope of the financial statement audit varies depending on jurisdictions, and there will be continuing movements surrounding such

information. In addition, even within one jurisdiction, needs for such information varies depending on the size of the entity as well as the type of the users. Therefore, if IAASB moves forward with developing standards for other assurance or related service on such information, as a first step, such standard should be established as a separate standard from standards for the financial statement audit. This approach gives jurisdictions flexibility so that they can incorporate standards in response to their relevant circumstances. Also, it would avoid circumstances that the financial statement audit would be affected by unintended consequence caused by the change. In addition, compared to a case where additional work was performed within the current scope of the financial statement audit, this would allow the auditor to secure sufficient time and resource for new engagement. That would lead to enhancement of the quality of financial reporting as a whole.

(Comment on Question 15)

- We believe the development of the criteria for preparers is prerequisite for further development of such assurance or related services. At the same time, we believe collaboration with the standard setter for preparers from an early stage would be important. In order to secure relevance and quality of subject matter information as well as assurance or related services on such information, at the stage of the development of criteria for prepares, it is important that the assurance standard setter monitors relevant process, and is involved in the process as necessary.
- In addition, if the information has different characteristics from historical financial information, it may be necessary to develop environment for the entity to prepare the information, and the auditor to provide assurance or relevant services on the information. For example, regarding future-oriented information, estimation uncertainty is relatively high, as compared to historical financial information. Therefore, it would be necessary to consider safeguard measures and to limit liability of the entity and the auditor.

Questions

16. Respondents are requested to identify benefits, costs and other implications of change, or potential challenges they believe are associated with the different options explored in Section III.
17. Do respondents believe the benefits, costs, potential challenges and other implications of change are the same for all types of entity? If not, please explain how they may differ.
18. Which, if any, of the options explored in Section III, either individually or in combination, do respondents believe would be most effective in enhancing auditor reporting, keeping in mind benefits, costs, potential challenges and other implications in each case? In this regard, do respondents believe there are opportunities for collaboration with others that the IAASB should

explore, particularly with respect to the options described in Section III, Parts D and E, which envisage changes outside the scope of the existing auditor reporting model and scope of the financial statement audit?

19. Are there other suggestions for change to auditor reporting to narrow the —information gap perceived by users or to improve the communicative value of the auditor’s report?

(Comment on Question 16)

- Please see our comments above.

(Comment on Question 17)

- We believe the answer as to whether implications of changes are the same for all types of entities varies between options. For example, the implications of the option to change the general content or format of the auditor’s report may be the same regardless of types of the entity. On the other hand, the implications of other options would be different depending on the size of an entity or scope of relevant stakeholders.

(Comment on Question 18)

- From a long term perspective, we believe option E would be most effective in enhancing financial reporting as a whole. By the entity providing necessary information, and by the external auditor providing assurance or relevant services on such information, the quality of the whole financial reporting process, including audit/assurance would be enhanced, without unintended consequence to financial statement audit.
- Regarding option E, as stated in our comment to Question 15, at the stage of developing criteria for preparers, it is important that assurance standard setter monitors relevant development and involve in the process, as necessary.

(Comment on Question 19)

We have no specific suggestions.

Sincerely yours,

Sayaka Sumida

Executive Board Member - Auditing Standards

The Japanese Institute of Certified Public Accountants