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16 September 2011

Mr James Gunn
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

By email via www.iaasb.org

Dear James

CONSULTATION PAPER – ENHANCING THE VALUE OF AUDITOR REPORTING: EXPLORING OPTIONS FOR CHANGE

Thank you for the opportunity to provide comment on this topic.

Pitcher Partners is an association of independent firms operating from all major cities in Australia. Our clients come from a wide range of industries and include listed and non-listed entities, large private businesses, family groups, government entities and small-to- medium-sized enterprises.

We observe that in this project and others the IAASB seems to have segmented the market for audit services into two extremes, being the audits of large, more complex entities and audits of small non-complex entities. There is no real recognition by the IAASB of audit issues relating to growing businesses, or businesses that are transitioning from the private segment to publicly listed companies, with changing stakeholder interests. The audit issues in respect of growing businesses are relevant not only for Australia, but also for businesses in the emerging economies in the Asia-Pacific region and therefore this segment requires focussed consideration for enhanced auditor reporting. This large middle-market segment should be recognised and given due consideration as this is the segment from which we will see substantial economic growth in the future, and especially if accountability and governance practices are well-established. It is not sufficient to limit discussion to small entities, and those with well-established governance structures.



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The views represented in our submission are based on our experiences in the middle market.

The role of auditors has attracted considerable media and regulatory attention in recent years and is still a focus of attention. The auditor's report is an important communication to stakeholders and is often the only mandatory public communication from the auditor. The *concise standard format* of the auditor's report is *immediately recognisable* to stakeholders. It captures the results of considerable time and effort extended in an audit, often by a *team* of audit professionals, who follow a comprehensive program of audit planning and execution that includes mandatory requirements set out in auditing standards.

In the past two decades, there have been significant changes in the global economy and local business environments. The growth of capital markets, the internet, and widespread use of technology (amongst other factors) have facilitated the flow of information, and consequently the financial report is rarely the only source of financial information available to stakeholders.

Alongside the environmental changes during that period, auditing standards have been revised and updated and now comprise a substantial body of audit requirements supported by comprehensive application and other explanatory materials. Further, regulatory oversight of the audit function has added another layer of conformity, which ensures a uniform approach to audits carried out at a consistently high standard.

Despite significant environmental changes, the basic format of auditors' reports under Australian Auditing Standards (which are consistent with the International Standards on Auditing) have undergone very little change. In contrast to a pro-forma example report presented in auditing standards in 1995, an auditor's report in 2011 includes a brief paragraph on management's responsibility for the financial report. The 2011 report also contains a more comprehensive, yet very technical description of the auditor's responsibilities (suitably identified by a sub-heading), in comparison to a very general description of the objectives of an audit in the 1995 report. Nonetheless, the changes in format are minimal when compared to changes in the reporting regime.

As stakeholders face complexity in financial reporting - both technical complexity and a large volume of financial and non-financial information, the audit function plays an increasingly important role. In exploring options for change the IAASB has a tremendous opportunity to address stakeholder needs for ***clear understandable information***, presented in a report by an independent professional, in respect of the financial condition of an entity as explained in the financial report. This means:

- Using *plain language* that any investor can understand, thus avoiding "audit-speak" that captures technical audit terms and phrases where the subtlety of meaning is only understandable to those writing audit methodologies;
- Making available *plain language explanation* of the objectives of an audit, differentiating between the role of management and the auditor;
- Recognising the need for an increase in stakeholder education about the audit function so that the complex task of planning and executing an audit is *not*

compressed into a single paragraph in an auditor's report thus providing cryptic information;

- Recognising that stakeholders have access to many different sources of information and consequently supporting information does not need to be compressed into a single report in a cryptic format, but can be referenced to a publicly available source;
- Recognising that *more* pro-forma standard form information in an auditor's report does *not necessarily mean better* information for stakeholders; rather risks arising from 'information overload' increases.

In our experience stakeholders focus attention on the auditor's opinion paragraph and on any modifications or emphasis of matter paragraphs in the auditor's report, and they rarely read the words in the supporting information. Consequently, as all audits (except where there are limitations of scope) follow the same requirements as set out in auditing standards, there is little need to restate the same explanation in each and every report, and particularly when those explanations use technical terms and phrases ("audit-speak") with limited understandability to a wider stakeholder group.

We recommend that the IAASB should develop an 'easy-to-read' short-form publication to explain an audit, which is readily accessible to all stakeholders. This strategy would not only enable better widespread education of stakeholders, but also the IAASB would be able to focus attention on a short-form statement that directly addresses stakeholder needs by providing a clear report of the auditor's opinion and description of exceptional circumstances only (i.e. qualifications and modifications).

We are also seriously concerned that the auditor's report should *not* be used to provide explanation of accounting estimates and judgments that are management's responsibility, as suggested through adoption of a 'justification of assessments' approach. Whatever the requirements of the accounting framework adopted, in our view management has an over-arching responsibility to provide further information as necessary in the notes to the financial statements, to enable users to understand the financial information presented. If that information is deficient, we consider that a modification to the auditor's opinion is required.

Our responses to your specific questions for comment are provided in the attachment to this letter. Please do not hesitate to contact me if there are matters arising which require further clarification.

Yours sincerely



S D AZOOR HUGHES
Partner

Issues Identified

1. Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?

- The notes to financial statements prepared in accordance with International Financial Reporting Standards contain vast amounts of information about the entity, its plans for the future and the risks that it faces (i.e. all the information referred to in paragraph 23).
- However, this information needs to be extracted from detailed note disclosures. It is possibly the form in which that information is delivered that presents the most problem, rather than a lack of content.
- Complexity in financial reports arises from complexity in the nature and extent of operations and transactions entered into by the entity. Often it is difficult to provide summarised information relating to complex activities in the note disclosures – yet note disclosures are already considered to be too lengthy and complex. To imagine that an auditor can provide a much more concise appraisal in the auditor’s report is quite unrealistic.
- The IAASB seems to have segmented the market for audit services into audits of large complex entities and audits of small non-complex entities. The paragraphs providing perspectives for audits of smaller entities are somewhat superficial and there is no recognition of issues relating to growing businesses or businesses that are transitioning from the private segment to publicly listed companies. When businesses are in a growth phase their implementation of internal controls and their response to regulatory compliance often lags behind their rate of growth. These issues are relevant for growing companies in Australia and the Asia-Pacific region and therefore this segment also requires more extensive consideration for enhanced auditor reporting.

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?

- In our experience, users from all segments of the audit market rarely actually read the auditor’s report except for the opinion paragraph and any qualifications or modifications.
- The most significant contextual difference in respect of small and large audits is that the auditor’s report is *not* the most significant form of communication from the auditor to an SME as there are many channels for *regular communication* in both directions. The ability to communicate regularly decreases as the governance structure becomes more complex i.e.
 - In an owner-managed entity accessibility to both decision-makers and stakeholders can be achieved with minimal effort simultaneously.
 - In contrast, communications with decision-makers in listed companies (being the board of directors) requires planning and preparation as non-executive directors are unlikely to be accessible throughout the course

of an audit. Further, the stakeholders in a listed entity are not individually accessible to the auditor.

- We do not consider that more information in the auditor’s report will address the expectation gap. There is a greater need for financial literacy amongst stakeholders and for their understanding of governance arrangements.
- We consider that a more concise auditor’s report *with reference* to a more comprehensive publication providing explanation of directors and auditors’ responsibilities, written in simple language, freely available (including on an authoritative web site), would be preferable.
 - For example, in Australia, reference could be to a publication of the AUASB or IAASB that explains in plain English the terms the scope and objectives of an audit. Similarly, regarding directors’ responsibilities, reference could be to a Treasury publication or a publication of the Australian Institute of Company Directors to explain responsibilities that apply in Australia.

3. Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities?

- Any changes should be applied to all types of entities to deter any type of ‘competitive advantage’ being communicated through the auditor’s report – this is not the role of audit.
- Further, in a dynamic business environment businesses transition from owner-operated, to broader public shareholdings, to listing on a securities exchange. It is important that the same level of audit scrutiny is applied as the entity transitions through various regulatory thresholds and differential reporting requirements.

Exploring Options for Change

A. Format and Structure of the Standard Auditor’s Report

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?

- The auditor’s report contains many references to terms that are only understood by other technical auditors (“audit speak”). Further, the significance of the use of particular technical phrases is often not even properly understood by practitioners. “Audit-speak” is not useful to stakeholders.
- However, if these terms were expanded to more colloquial expressions rather than by reference to the language used in auditing standards, the expectation gap would probably increase and therefore we do not suggest that course of action.
- In contrast as noted in the last bullet point under question 2 above, we consider that a more concise auditor’s report *with reference* to a more comprehensive publication providing explanation of management’s and auditors’ responsibilities, written in simple language, freely available (including on an authoritative web site), would be preferable.

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?

- Even if these paragraphs were expanded, they could only provide a compressed explanation of responsibilities. Further, it is unlikely that 'plain language' explanations could be compressed into one or two paragraphs. We consider that reference to a short-form separate publication would be more worthwhile.

B. Other Information in Documents Containing Audited Financial Statements

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?

- Refer to comments in the last bullet point under question 2 above – we do not believe that more content will be beneficial. However, this point could be explained more thoroughly in a publication explaining the scope of an audit.
- In particular, we consider that statements about what the auditor has *not* done could be confusing to stakeholders. What else should be included in this context?
- The auditor's report should clearly identify the information that has been audited; it is not practicable to extend these responsibilities in an 'information rich' age.

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?

- The auditor's report should only refer to information that has been audited.

C. Auditor Commentary on Matters Significant to Users' Understanding of the Audited Financial Statements, or of the Audit

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.

- Refer to question 9 below

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.

- The examples of auditor's reports issued in France contain 'standard form' disclosures, which are very similar to standard form accounting policy notes provided in pro-forma example financial reports prepared in accordance with International Financial Reporting Standards.
- Given such information is already provided in the notes to the financial report, we question how it adds value by being repeated in the auditor's report.

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.

- This is a dangerous pathway – how is quality to be determined? Expectations are likely to change depending on the size and nature of the entity, its funding base, industry standards etc. This disclosure will be particularly difficult for growing businesses that need to balance reporting demands with use of resources to address other priorities that enable their businesses to grow. Except where there is an established governance structure (as with large listed entities), this will be an extremely subjective judgment and may disclose sensitive information that is detrimental for growing businesses.
- Further, a judgment relating to the quality of financial reporting is a relative measure and may depend on the experience of the auditor, or familiarity with particular systems or industries. Consequently, unless there are operational or quality control standards that can be used as the criteria to assess 'quality', the judgment will not depend on the 'quality' of the entity's financial reporting per se.

D. An Enhanced Corporate Governance Model: Role of Those Charged with Governance regarding Financial Reporting and the External Audit

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.

- Corporate governance practices are not necessarily understandable to a person with no experience in this field. Further the results of effective corporate governance practices will be reflected in the financial performance reported to stakeholders.
- We consider that improving private reporting between the auditor and those charged with governance (i.e. those with both understanding and responsibility) is appropriate.
- We generally do not support public disclosure of matters described in paragraph 88 by either the company or the auditor as an in-depth understanding of the entity, the business environment in which it operates, constraints on resources, cost/benefit analysis etc. is needed to be able to make valid judgments about these matters.

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?

- We do not support this model. We consider that it is excessively onerous and will put undue emphasis on the ‘form’ of governance rather than the ‘substance’ of governance practices. This kind of analysis may be particularly difficult and subjective for businesses in a growth phase.

13. Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?

- We do not consider that a detailed report by those charged with governance is appropriate for use by general stakeholders.

E. Other Assurance or Related Services on Information Not Within the Current Scope of the Financial Statement Audit

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.

- We consider that there is value in providing assurance services for this type of information, but would support private reporting to those charged with governance, rather than public reporting to the wider group of stakeholders. This type of information needs an in-depth understanding of the entity, the business environment in which it operates, constraints on resources, cost/benefit analysis etc. to be able to make valid judgments about these matters.

15. What actions are necessary to influence further development of such assurance or related services?

- These services are already being provided when requested. We consider that the market will continue to evolve as a better understanding of corporate governance practices is embraced by boards.

Implications of Change and Potential Implementation Challenges

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.

- We do not support this model. We consider that is excessively onerous and will put undue emphasis on the ‘form’ of governance rather than the ‘substance’ of governance practices. This kind of analysis may be particularly difficult and subjective for businesses in a growth phase.

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.

- Entities that operate in listed markets are more likely to have an established corporate governance structure and therefore may be more suited to these types of disclosure. However, in the Australian listed market there are many “small-caps” and start-ups and these types of disclosure could inhibit investment and their economic growth.

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?

- We are in an age of information overload and do not consider that providing more information to users will necessarily meet their needs. Auditors’ reports need to be more concise and written in plain language with a clear reference to a recognised source where a user can find out more information about the audit process and the entity’s governance arrangements.

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?

- Refer to the last comment above
- The expectation gap needs to be addressed more broadly in the community as the auditor’s report is “after the event”. It would be preferable for stakeholders to have a clear understanding of the audit function prior to receiving an auditor’s report. This can be achieved by producing, promoting and widely-disseminating a plain language short-form publication that provides a non-technical person with a clear understanding of the service delivered. While this form of communication may not have been appropriate two decades ago, with digital communications, emails and web-sites, such information can be delivered quickly in a cost-effective manner in today’s world.