

Auditing Standards Committee
Auditing Section – American Accounting Association

October 3, 2012

Via IAASB website (revised letter)

RE: Invitation to comment on *Improving the auditor's report*

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on your recent Invitation to Comment on your proposal entitled *Improving the Auditor's Report*.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

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Responses to Specific Questions in the Invitation to Comment

- 1. Overall, do you believe the IAASB suggested improvements sufficiently increase relevance and informational value of the auditor's report, in view of possible impediments (including costs)? Why or why not?**

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There is evidence to believe that the auditor report in its current form is not sufficiently informative. As we discuss in our Comments to a similar proposal released by Public Companies Oversight Board in 2011 (Brazel et al 2011), enhancements to the traditional format of the auditor's report have potential to make auditor report more relevant to financial decision making.

Using the US evidence as an example, Brazel et al (2011) show that the absolute majority of audit reports are unqualified. Within population of unqualified audit opinions, going concern opinions tend to be the only ones that have a valuation and cost of capital impact, and thus are viewed as informative by investors (Knechel et al 2012). Thus, binary nature of audit report in its current format is not very useful. This is consistent with interview evidence presented in Vanstraelen et al (2012).

However, audit report does have the potential to provide more value relevant information to users of financial statements, such as creditors, stockholders, regulators, and other stakeholders. In particular, this is because auditors have unique vantage point from which to view the quality of financial information released to the outside users (e.g., from the stand point of audit adjustments passed, the relationship between mandated and voluntary disclosures made). Thus, requiring that auditors provide more information is, in principle, a good thing.

However, the cost of providing such information must be considered as well. As noted throughout this response, the costs of many of the proposed changes include, but are not limited to, information overload (i.e., the auditor providing too much information in the report). If the new proposed information is not clearly delineated or restricted in some manner, there is a risk that auditors will provide too much information (to protect themselves from the legal liability of not providing a specific piece of information). This leads to the possibility that additional information could actually lead to less relevance and informational value. This notion of "information overload" is particularly important because recent research clearly indicates that when investors are furnished with "too much" information, they tend to ignore it (Hirshleifer et al, 2004). Thus, in our view, IAASB should think more about what kind of additional information disclosure is more likely to have most salient impact on the stakeholders' use of information in the expanded auditor report.

In addition, before making any changes to the report, the IAASB should consider the financial incentives with respect to the dissemination of more information. Since audit fees are paid by the client, auditors have financial incentive to maintain a healthy client relationship. In addition, auditors have financial incentive to avoid litigation. The client has financial incentive to disseminate information that enhances the public's perception of the firm. The interaction of these incentives may not necessarily lead to more informative disclosures if the IAASB suggested improvements are adopted. More informative information relative to its peers that casts the client in a negative light will put the auditor in a tricky position with respect to the client – especially if the information is not mandated and is subjective. In addition, due to litigation risk, auditors have a complete aversion to providing any non-mandated information about the client to the public. Thus, any additional

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disclosures will likely become boilerplate. First, audit firms' legal counsel will advise against providing any information that is unnecessary to fulfill statutory or regulatory requirements. Second, clients will demand that auditors not provide any additional information above what is provided by the auditors of their competitors – which will also likely be boilerplate. Clients will likely seek auditors known for providing boilerplate audit reports. Thus, the IAASB would be wise to consider requiring specific guidance on what additional information must be disclosed if the proposed changes are to illicit meaningful new information about the client.

2. Are there other alternatives to improve the auditor's report, or auditor reporting more broadly that should be further considered by the IAASB, either alone or in coordination with others? Please explain your answer.

As previously mentioned, many of the improvements should go a long way towards improving the audit report. However, as discussed above and throughout this document, the IAASB needs to consider placing limitations on this additional information. If the additional information content is left to the auditor and his/her judgment, then the report may become too long.

3. Do you believe the concept of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report? Why or why not? (See paragraphs 35–64.)

We believe this commentary is potentially very useful. However, our concern, again, is that this section could easily balloon if it is not actively restricted (i.e. to specific types of information the auditor would be required to comment on). For instance, your proposal mentions that “any matter identified by the auditor as a significant risk generally would be the subject of discussion with TCWG and therefore would be an important consideration as a matter to include in Auditor Commentary”. As is stated currently, this inclusion is too broad. Audit risks vary widely, and it is unclear whether inclusion of all risks discussed with TCWG would serve a helpful purpose. Rather, auditors should focus on discussing risks that would materially impact investor valuation judgments, or would affect regulators' views of a firm. We therefore concur with your comment that investors may misinterpret such risk disclosures. We agree with your suggested list of matters to be included into the Auditor commentary (e.g. such as significant accounting policies, estimates and financial statement disclosures, related party transactions, non-financial disclosure on corporate social responsibility, and other matters of audit significance). Prior research shows that the majority of these items tend to affect the judgments of users of financial statements. The only concern that we have with this list is that it may already overlap with disclosures provided in the audited financial statements, and thus would simply represent a duplication of effort on the part of auditors and their clients. In addition, when it comes to the US firms, some of these matters already have to be disclosed as part of auditor resignation/dismissal process.

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- 4. Do you agree that the matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, with guidance in the standards to inform the auditor's judgment? Why or why not? If not, what do you believe should be done to further facilitate the auditor's decision-making process in selecting the matters to include in Auditor Commentary? (See paragraphs 43–50.)**

Again, if the content of this section is left to the judgment of the auditor, the auditor may feel it necessary to comment on "too much" information to protect themselves from possible litigation, which in turn could lead to a de-valuing of the information that is discussed. In contrast, if the section were limited to specific types of information, the auditor would likely not be driven to conservatively include information in order to protect themselves legally.

One area of concern here is cross-country variation in litigation risk. We know from research on voluntary disclosure that in regimes with lower litigation risk, issuers are more likely to provide information (e.g., Baginsky et al 2002). So we should reasonably expect that in countries with lower litigation risk, auditors will be more forthcoming with their disclosures, and vice versa. Thus, it may be difficult to compare audit commentaries across different regimes. Bearing that in mind, it may be useful to have a list of mandated elements of Auditor Commentary.

- 5. Do the illustrative examples of Auditor Commentary have the informational or decision-making value users seek? Why or why not? If not, what aspects are not valuable, or what is missing? Specifically, what are your views about including a description of audit procedures and related results in Auditor Commentary? (See paragraphs 58–61.)**

In many instances, this section seems to reiterate information that is found in the footnotes. Again, this could result in this section ballooning to reference many, or even all, of the footnotes in the financial statements and the auditors' procedures regarding the content of each footnote. It could also result in the Auditor Commentary section evolving into "boilerplate" language regarding many accounts common to most entities (Cash, AR, Notes Payable, etc), which would act counter to the intent of providing more useful (as opposed to simply more) information.

- 6. What are the implications for the financial reporting process of including Auditor Commentary in the auditor's report, including implications for the roles of management and those charged with governance (TCWG), the timing of financial statements, and costs? (See paragraphs 38 and 62–64.)**

This wouldn't seem to alter these processes and roles much. However, as we discuss throughout this opinion letter, if the Auditor Commentary section balloons, the benefits may not accrue to stakeholders in the manner intended. This is consistent with the reported views of parties interviewed on the proposed auditor report (Vaenstraelen et al 2012).

- 7. Do you agree that providing Auditor Commentary for certain audits (e.g., audits of**

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public interest entities (PIEs)), and leaving its inclusion to the discretion of the auditor for other audits is appropriate? Why or why not? If not, what other criteria might be used for determining the audits for which Auditor Commentary should be provided? (See paragraphs 51–56.)

We do not believe this section should be required for specific types of audits because it may lead to additional confusion on the part of audit report users. Moreover, a concept of PIE is not universal (for example, in the US, it is not used), and hence adoption of such additional requirements may lead to loss of generalizability of an auditor's report. Rather, the specific information that auditors must discuss should be clearly outlined and limited for the reasons discussed throughout this document.

8. What are your views on the value and impediments of the suggested auditor statements related to going concern, which address the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified? Do you believe these statements provide useful information and are appropriate? Why or why not? (See paragraphs 24–34.)

These statements clearly provide useful and appropriate information. Our general view is that it is extremely important for the auditor to evaluate management's use of the going concern assumption and report their evaluation in the audit report.

However, there is a fear that this additional opinion would expose audit firms and their clients to a number of costs including increased audit fees spurred by increased litigation risk and an expansion of the "expectation gap". Further, there have been no explicit calls from the user community for expanded going concern disclosures and the IAASB proposal has not described the expected benefits of this proposed change. Ultimately, there is concern that the expected costs of the going concern opinion in the auditor report could outweigh any potential benefits.

Questionable Impetus and Benefits

The IAASB claims that the proposed going concern opinion represents a middle ground between low impediments / low value and high impediments / high value options and attempts to address concerns raised during the global financial crisis. In paragraph 24 of the IAASB ITC, the Board states that some respondents to its May 2011 consultation paper asked for clarification of management's and audit's respective responsibilities regarding the going concern assumption. Further, some respondents asked, "for auditors to report the outcome of their work regarding going concern." Unfortunately, the IAASB has not provided further detail about the demands from users regarding this expanded disclosure.

In June 2011 the PCAOB put forth PCAOB Release No. 2011-003: Concept Release on Possible Revisions to PCAOB Standards related to Reports on Audited Financial Statements notably lacking expanded going concern disclosures in the audit report required in the U.S. Further, in March of 2012, the PCAOB asked members of its Investor Advisory Group (IAG) to complete a survey regarding going concern disclosures. While 75% of the

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respondents believed that, “an auditor should identify in their report, if they believe the company will not continue as a going concern,” mandating expanded going concern disclosures was not considered. Additionally, only 36% of respondents believed that the independent auditor should maintain primary responsibility for reporting to investors whether or not the audit client will continue as a going concern. Based on the results of the survey, the IAG did not recommend expanding auditor public disclosures regarding going concern evaluations.

Additionally, the IAASB has not specified the benefits of the going concern opinion in the auditor’s report. In paragraph 27, the ITC explains that, “The IAASB believes that additional value would be provided to users... by a statement that material uncertainties have not been identified” but fails to expound on this claim. ISA 570 (paragraphs 17 – 21) already mandates auditor disclosures for different situations related to going concern uncertainties and the going concern assumption has been maintained in financial reports for decades. Potential benefits for sophisticated users of financial statements stemming from stating the assumption explicitly would be negligible.

Additional Costs

Entities subject to the requirements of the expanded auditor report should expect to incur higher audit fees related to the expanded going concern disclosures. By creating a required going concern opinion, the IAASB will expand audit risk, which captures the likelihood of providing an unmodified going concern in the auditor report immediately preceding a bankruptcy or other business failure. Auditors use the audit risk model (ARM) for planning and audit pricing purposes and an increase in assessed audit risk would ultimately increase the cost of each audit (Houston, Peters, and Pratt 1999). Further, the expanded going concern disclosure may expose audit firms to additional litigation even though the ITC illustrative report states that, “the absence of material uncertainties is not a guarantee as to the entity’s ability to continue as a going concern” (paragraph 27).

Later in paragraph 27 of the ITC, the IAASB admits that,

“including an explicit statement about the absence of material uncertainties may lead to a misinterpretation by users that the auditor is providing a conclusion about the entity’s future viability, potentially resulting in a widening, rather than a narrowing, of the expectations gap.”

By mandating a new disclosure prone to misinterpretation by users of financial statements, the proposed change may ultimately harm investors, especially considering the long-standing use of the going concern assumption and the current reporting model. Financial statement users explicitly understand the current reporting model and find it valuable for decision-making. For example, in a separate PCAOB IAG survey, the chief investment officer for a mutual fund noted that the standard audit report in the U.S., “provides meaningful information in extreme circumstances, usually around going-concern issues” (Carcello 2012, p.24). The IAASB would risk decreasing the value of the current going concern reporting model by introducing the potential misinterpretation inherent in the new reporting model.

Conclusion

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While other changes to the auditor's report proposed in the IAASB's ITC may provide net benefits to the users of financial statements, we believe that the costs of introducing the revised going concern reporting models would far outweigh the potential benefits. The impetus for changing a well-understood reporting model has not been clearly enumerated and the benefits to the change remain vague and improbable. Further, requiring each auditor report to include a separate going concern opinion will result higher costs to users, financial statement preparers, and audit firms in the form of a widened expectations gap, greater possibility for misinterpretation, increased audit fees and increased audit risk."

9. What are your views on the value and impediments of including additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statement that no material uncertainties have been identified? (See paragraphs 30–31.)

We do not believe this is necessary. By agreeing, for example, with management's assertion that there is not a going-concern issue, the auditor is providing, in our view, enough information on this subject. Requiring the auditor to outline the judgments made that led to this opinion would not seem to be worth the costs to the financial statement user. In the case where a going-concern issue is present, it would seem the auditor, by stating this in the report, is providing enough information to stakeholders to take action in obtaining additional information where necessary. This goes back to our aforementioned discussion of the litigation risk. In countries, where auditor and class-action investor litigation is rare, this may be OK to allow auditors to provide information about their judgments. In countries, such as the U.S., this would expose auditor to higher liability, and it is thus highly unlikely that the U.S. auditors would be willing to provide anything informative in this section.

10. What are your views on the value and impediments of the suggested auditor statement in relation to other information? (See paragraphs 65–71.)

Our views on this are consistent with the proposal outlined in paragraphs 65-71. An increase in the expectations gap is possible. However, stakeholders have a responsibility to understand what auditors are and are not responsible for. Expanding the audit report in the manner proposed by the IAASB can provide additional information that is very valuable to different stakeholders. However, as the report begins to venture into the areas of providing information about the auditor's judgment of specific issues, including the Other Information section, it is incumbent on auditors to clearly outline in the audit report what is officially being attested to and what is being provided as useful information without an explicit attestation. The Other Information section needs to state clearly that the auditor is not charged with actively seeking out material inconsistencies between the audited financial statements and other information, rather the responsibility is limited to reporting inconsistencies when the auditor finds them.

For example, information on corporate social responsibility (CSR) is shown to be negatively associated with operational risk (McGuire et al., 1988), earnings manipulation, and

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regulatory risk (Kim et al., 2011); in addition, good CSR performance helps mitigate the future litigation risk against the firm and the auditor (Chen et al. 2012). As stakeholders around the world are paying increasing attention to CSR, we believe it is imperative to include a statement about the auditor's responsibilities regarding other information such as CSR in the auditor's report. On a related note, Germany passed the Accounting Law Reform Act in 2004 mandating the inclusion and regular audit of key CSR performance indicators (such as information on environmental and employee matters) in the annual reports (Helm, Liehr-Gobbers, and Storck 2011).

12. What are your views on the value and impediments of disclosing the name of the engagement partner? (See paragraphs 72–73.)

Our belief is that more transparency is better given that auditors are charged with a very important capital market function. Therefore, we support the disclosure of the name of the engagement partner as stakeholders can infer audit quality on a more refined level (rather than simply the audit firm level). We took a similar view in our comment to partner name disclosure by PCAOB in early 2012 (Jones et al. 2012). Recent work further suggests that financial statement quality tends to vary by partner (Chi et al. 2012, Knechel et al 2012). Hence, disclosures of partner names have the potential to be highly useful to investors. Quite a few countries already (e.g., Australia, Taiwan, Sweden, China) require disclosure of engagement partner names. Using this data, researchers have concluded that engagement partner characteristics matter to audit quality. For example, Chi et al. (2012) and Wang et al. (2012) use data from Taiwan and data from China respectively and find that an audit partner's experience (pre-client and client-specific experience) is associated with higher actual and perceived audit quality. Knechel et al. (2011) show that partner compensation policies affect audit quality in Swedish clients. Gul et al. (2011) examine the importance of individual auditors in determining audit quality using a large set of archival Chinese data. They find that there is a significant variation in audit quality across individual auditors. These individual auditor effects on audit quality can be partially explained by the auditors' characteristics such as educational background, Big N audit firm experience, rank in the audit firm, and political background. Taken together, this stream of research suggests that investors will find disclosure of audit partner names useful.

We note that audit partners might be resistant to the idea of having their names disclosed in the audit reports. They might argue that this requirement would expose them to too much litigation risk. However, from the shareholders' point of view, it is beneficial to have the audit partners' names disclosed.

13. What are your views on the value and impediments of the suggested disclosure regarding the involvement of other auditors? Do you believe that such a disclosure should be included in all relevant circumstances, or left to the auditor's judgment as part of Auditor Commentary? (See paragraphs 77–80.)

We believe disclosure regarding the involvement of other auditors may or may not be important depending on the specific services performed by other auditors. If the work is

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"material" in nature, it should be disclosed. This is consistent with our comment to a similar PCAOB proposal (Jones et al. 2012). We believe investors would like to know who participated in the audit besides the engagement partner. All individuals who perform the work together determine the quality of the work. Behavioral research in accounting suggests that easily accessible information is more effectively and efficiently used by consumers of accounting information. Thus, if investors knew the names of the participants, they would be better informed to make a judgment regarding the quality of the overall audit. It is also important to know the percentage of hours attributed to other participants so investors can form a judgment regarding the quality of the overall audit. The requirement is particularly relevant for multinational audits where the main auditor relies on other audit firms or their branch offices to conduct a part of the audit process. In addition, a requirement to disclose other participants in the audit would lead to more research in this area that would inform investors and regulators about the quality of work provided by "other participants."

The PCAOB synthesis report by Bierstaker et al. (2012) provides a related discussion on the involvement of other auditors when aspects of the financial reporting process are outsourced. Auditing standards require auditors to corroborate management's representations by obtaining information from independent third parties, and allow auditors to rely on the evidence collected by internal auditors and other specialists in forming their opinions (PCAOB 2007). The audit profession has long recognized the benefits of appropriate reliance on the work of others to improve audit efficiency (Gramling et al., 2004), and auditors use their professional judgment to determine the manner and extent of their reliance on the work of others (Brown 1983; Messier and Schneider 1988). Thus we believe such a disclosure can also be left to the auditor's judgment as part of Auditor Commentary.

16. What are your views regarding the need for global consistency in auditors' reports when ISAs, or national auditing standards that incorporate or are otherwise based on ISAs, are used? (See paragraphs 21–23 and 87–90.)

We believe consistency here is extremely important to the extent it can be implemented in different jurisdictions. Value relevance to various stakeholders is reduced when stakeholders are forced to interpret different reporting standards and to compare these differences across jurisdictions. This is especially important in light of our aforementioned comments on cross-country variation in litigation risk. In addition, other factors may influence the manner and the amount of disclosure auditors in different countries may be willing to provide, such as that country's culture, level of investor protection, and disclosure regimes.¹ The best way to deal with these different disclosure incentives is to be as precise as possible in the kind of disclosures auditors are expected to provide.

17. What are your views as to whether the IAASB should mandate the ordering of items in a manner similar to that shown in the illustrative report, unless law or regulation require otherwise? Would this provide sufficient flexibility to accommodate national reporting requirements or practices? (See paragraph 17 and Appendix 4.)

¹ Recent paper by Pevzner et al. (2012) discusses some of these issues.

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In light of a comment #16, we agree with the proposals here. Given the cross-jurisdiction nature of the IAASB, it would seem straight-forward enough to add a section that addresses specific regulatory requirements at the bottom of this section.

- 18. In your view, are the IAASB’s suggested improvements appropriate for entities of all sizes and in both the public and private sectors? What considerations specific to audits of small- and medium-sized entities (SMEs) and public sector entities should the IAASB further take into account in approaching its standard-setting proposals? (See paragraphs 91–95.)**

As always, the audit function is one of benefits and costs. For SMEs the costs of adhering to regulations can be severe and the benefits are sometimes not justified. However, it seems that the costs of the proposed requirements under the Auditor's Responsibility section would seem to be justified in light of the benefits, even for SMEs since this section simply provides information about the auditor's findings during the audit. However, again, if this section is not limited, its usefulness may be limited. This would seem to be especially true in the case of SMEs.

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