

## ASIAN CORPORATE GOVERNANCE ASSOCIATION

### Response to the IAASB consultation on "Improving the Audit Report"

October 2012

ACGA welcomes the opportunity to respond to the consultation paper by the International Auditing and Assurance Standards Board (IAASB) on *Improving the Auditor's Report*. Our submission contains responses on selected issues in the consultation paper. We would be pleased to discuss these issues further with IAASB.

#### Introduction

While we believe that investors value the current binary opinion in auditor reports—as this gives a clear pass or fail on whether the financial accounts give a true and fair view of a company—we agree that there is room for improvement in the rest of the report. The typical one-page statements provided with audited accounts fail to provide much additional meaningful information.

Auditors are clearly closer to management than most of a company's shareholders and aware of information that could be of great value to investors. As suggested in the IAASB paper, auditors could potentially highlight matters that would help shareholders understand the audited financial statement as well as the audit better.

As financial misinformation or outright fraud has come to the fore around the world over the past few years, it has become increasingly important for auditors to clarify their role in these situations and explain, or re-explain, the normal scope of an audit. Since shareholders formally appoint auditors at annual shareholder meetings in most jurisdictions, it is reasonable to expect that auditors should seek to engage with shareholders as well as management. Indeed, many global audit firms have been focussing attention on such engagement since the global financial crisis.

#### Auditor Commentary

The concept of an expanded Auditor Commentary, as suggested by the IAASB, is a helpful starting point. It should be possible for auditors to communicate key issues to the shareholders of a company in such a way that does not either degenerate into boilerplate or introduce new and "original" information that should have been disclosed already by management.

We are not entirely convinced, however, that the general examples provided in the sample auditor's report are the right way to proceed. We appreciate this is a work in progress, yet the language on goodwill and fair valuation appears somewhat vague and could quickly become boilerplate. Not only would auditors say as little as possible to avoid liability, but any apparent negative statement that contradicted a more positive view put forward by management would almost certainly not see the light of day.

The same would apply to any description of the interaction between the auditor and "those charged with governance". Unless such commentary contained substantive information about actual issues discussed, we believe its value to investors would be minimal. Investors already expect auditors to be speaking with those charged with governance, especially the audit committee, hence to be told this has happened and to be given a list of general topics discussed may not add a great deal to an investor's understanding of a company.

An analogy could be drawn with the risk factors sections in IPO prospectuses. Although on first glance these seem quite useful, on closer inspection much of the language is formulaic and copied from earlier prospectuses. Moreover, it often appears that the aim of including such copious detail on risk factors is more about helping an investment-bank sponsor manage liability than to answer practical questions of interest to investors knowledgeable in the fundamentals of the particular industry.

We recognise that the IAASB is fully aware of the danger of the proposed Auditor Commentary becoming boilerplate. It therefore proposes that the matters to be included in the Commentary be left largely to the judgement of the auditor, but with some general guidance on the possible range of issues that could be addressed. We support this approach, subject to the caveats above. We strongly believe that the alternative—providing a list of “clear criteria”, as some are arguing for—would almost certainly degenerate into a checklist and become boilerplate. We urge the IAASB to be wary of such requests, especially from jurisdictions where there is a strong tendency to turn positive corporate governance principles into prescriptive rules whose unintended, or intended, consequence is to undermine the value of the reform. The history of the independent director concept in Asia is a good example of this process. Another analogy is with corporate governance statements and the report of directors in annual reports of listed companies: the more detailed and prescriptive the rules are, the more formulaic the language tends to become.

One potentially productive way forward would be for the Auditor Commentary to become a helpful guide for investors on how to read increasingly complex financial statements and notes in the most efficient manner possible. For example, the Commentary could signpost in a few short pages the key areas and topics that auditors believe investors should be aware of. What issues should investors prioritise in their analysis of the accounts or notes? What data shows the most change from the previous year? What risks need to be highlighted?

Such a guide could be brief and, if done well, would save users of accounts considerable time and enhance their understanding of the company. It would in no way introduce new or “original information” in the Commentary, since all the information would be in the notes to the accounts in more detailed form. It therefore could not cause harm to the company, undermine the value of an unqualified audit, or create an impression of conflict between what management is saying and what the auditor is saying.

As an aside, we would note that providing new and material information about a company is the obligation of management and the board under regulations covering the continuous disclosure of material information. If an auditor finds material inconsistencies in the accounts that the company has failed to report, then he or she should insist the management does so. If management fails to do so, and the inconsistency is sufficiently serious, then the auditor should produce a qualified opinion or resign as auditor and make a public statement as to why.

In addition to the Commentary being a helpful guide, we believe that there is merit in auditors also providing information on the planning and conduct of the audit, For example:

- Which areas of the accounts did the auditor concentrate most on and why;
- Key judgements made by the auditor in planning the audit, such as materiality and the scope of the audit;
- The extent to which they used third-party experts;

- The involvement of other auditors, including naming the other auditors/audit firms used and what they were specifically tasked with for the audit. ("Other auditors" would also include sister firms in other countries that have assisted with the audit.)

We also believe that the auditors should be required in the Commentary to provide description and data on the human resources they applied to the conduct of the audit, including time spent by the senior engagement partner, the partner:staff ratio in their firm, and the level of experience of the member of the audit team carrying out the audit. There is growing concern in the region, as reflected in reports published by independent audit regulators, that audit quality often suffers due to:

- Junior and inexperienced associates doing most of the work;
- Senior partners not spending enough time overseeing the work done by their junior colleagues (due to a variety of factors, such as too few senior partners to take on the workload);
- Downward pressure on audit fees, which acts as a disincentive to the auditor and affects their ability to pay competitive salaries in the marketplace and retain staff.

We would like to emphasise that we are not calling for auditors to produce long and technical descriptions of the actual audit process. While such information would be useful and educational for many investors, it could be best provided on the websites of national auditing standards boards.

Meanwhile, we believe that the Auditor Commentary should be required for all PIEs as well as all listed companies. We understand the concerns expressed in the consultation paper on the cost involved to companies on a more comprehensive auditor report, especially for SMEs, but we are of the opinion that different standards for different types of public / listed companies is not conducive to providing consistent and comparable reporting quality. If an SME is listed, it should be held to the same standards as other companies on an exchange. Indeed, some of the worst governance problems occur in SMEs.

### **Going Concern**

In principle, we support the IAASB recommendation that all auditor reports should include:

- i. A conclusion regarding the appropriateness of management's use of the going concern assumption; and
- ii. A statement regarding whether, based on the audit work performed, material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern have been identified.

However, there are legitimate fears that any uncertainty raised by an auditor about going concern could either undermine an unqualified opinion or, if misinterpreted, lead to a proverbial 'run on the bank'.

We suggest that more time is needed to think about these issues before any changes in standards are finalised. The issues raised in *The Sharman Inquiry: Final Report and Recommendations of the Panel of Inquiry*, which was released in June 2012 by the UK Financial Reporting Council, mirror our concerns: how "going concern" and "material uncertainty" are defined and reported. As we have stated above, auditors should not be responsible for revealing new information that a company or its management has failed to report to its stakeholders. If accounting standards on "going concern" and "material uncertainty" are not in line with auditing standards or with a jurisdiction's Listing Rules and its Code of Corporate Governance, then, as the Sharman Report states, "such inconsistencies may undermine the

effectiveness of the assessment process and the disclosure about the entity's going concern status and may create expectation gaps".

Moreover, the manner in which "material uncertainty" is defined in the various standards is inconsistent—something that many investors have noted—and we would urge the IAASB to work with the International Accounting Standards Board to "agree a common international understanding of the purposes of the going concern assessment and financial statement disclosures about going concern, and of the related thresholds and descriptions of a going concern, in the international accounting and auditing standards", as has been recommended in the Sharman Report.

We also endorse the need for the IAASB to engage with IOSCO to amend securities laws in different jurisdictions to establish an international regulatory framework that will allow for a consistent and comparable reporting of these two terms.

### **Transparency**

In the interests of transparency and audit integrity, we also urge the IAASB to require auditors to state explicitly that they did not assist their clients with accounts preparation during the audit process. This is a lingering issue in Asia because the evidence suggests that some listed companies do not have sufficient qualified personnel to finalise their accounts.

Some investors would also like to see auditors give a brief description of the non-audit work undertaken within the audit period by the audit firm, such as preparation or attestation of tax submission, submission of grants and deal introductions. If none has been undertaken, then an affirmative statement to that regard should be provided.

Finally, on the issue of whether the amended auditor's report should disclose the name of the engagement partner, we believe it should (even if he or she does not sign the report).

End.