



European Federation of Accountants and Auditors for SMEs

International Auditing and Assurance Standards Board ("IAASB")
529 Fifth Avenue, 6th Floor
New York, NY 10017
Attn. IAASB Technical Director
Brussels, 8 October 2012

Dear Sir

Response to IAASB Invitation to Comment – Improving the Auditor’s Report

The European Federation of Accountants and Auditors for SMEs ("EFAA") represents accountants and auditors providing professional services primarily to small and medium-sized entities ("SMEs") both within the European Union and Europe as a whole. Constituents are mainly small practitioners ("SMPs"), including a significant number of sole practitioners. EFAA's members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, tax and business advice) to SMEs.

General remarks

EFAA appreciates the opportunity to respond to the IAASB's Invitation to Comment ("ITC") – Improving the Auditor's Report. We commend the IAASB's ITC because it presents the issues clearly and succinctly.

We support this initiative which seeks to respond to the legitimate demands of stakeholders to make the auditor's report more relevant in the post-financial crisis environment. We welcome the IAASB's suggested improvements and we believe that they strike a good balance between global consistency and national flexibility; between comparability and relevance. Whilst expressing our support, we have overarching concerns on whether the exact balance between what is enough and what is too much information can ever be achieved to the satisfaction of the user and whether entity-specific information can be provided year-on-year that will not in time become boilerplate.

In the SME sector the cost / benefit evaluation of the proposals is markedly different to that for a Public Interest Entity ("PIE"); this is not just because the cost burden falls disproportionately on SMEs but also because the needs of investors and financial analysts, to which many aspects of this project respond, are not shared by the users of SME financial statements. That said, we are of the opinion that auditor's reports for SMEs should demonstrate the value of an audit. This is at the forefront of our considerations as in much of Europe the audit of small entities is commissioned voluntarily rather than being required by law.

We therefore call on the IAASB to ensure that any changes to auditor reporting are not to the detriment of SMEs. This is not just a matter of simple exemption from some proposals but the drafting of changes to International Standards of Auditing ("ISAs") should take account of the differences in user needs of SMEs and the circumstances in which audit occurs.

We specifically support the introduction of the so-called building block approach. To some degree this approach maintains the mantra of "an audit is an audit" whilst enabling proportionality of application of ISAs to accommodate the specific circumstance of SME audits.



European Federation of Accountants and Auditors for SMEs

We support the concept of Auditor Commentary as that can add value for users and welcome the proposal that it would only be mandatory for PIEs as the existing requirements for emphasis of matter and other matter paragraphs are appropriate to satisfy the information needs of users of SME financial statements.

We are sympathetic to the IAASB's suggested course of action on Going Concern with a caveat that this should not lead to an increase in the expectations gap but we do appreciate the drivers behind this issue and clearly some action is warranted.

Our comments on specific matters are set out below.

Overall considerations

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

No, the IAASB could go further. Changes to narrow the expectations and information gaps and increase the value of auditor reporting cannot be achieved through the auditor's report alone. A holistic solution necessarily involves increasing the content of financial statements beyond the requirements of the currently applicable reporting framework. This cannot be achieved in the short term.

Within the constraints of leaving the audit mandate unchanged, we welcome the IAASB's suggested improvements and we believe that they strike a good balance between global consistency and national flexibility; between comparability and relevance.

The issues dealt with in the ITC are more obviously relevant to companies listed on major capital markets because they respond to requests for more entity-specific information from mainly investors and financial analysts. As we explain in our answer to question 18 below, the specific circumstances of the SME audit are markedly different to those of the listed entities that are the focus of the proposals and that should be accommodated by the IAASB when taking the proposal forward.

Please refer also to our general remarks above.

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.

Explaining more precisely the audit methodology employed may help change user perceptions of audit, but users have different needs and levels of understanding; necessitating different approaches to meet those needs. Audit methodology can be highly complex and clarity of communication to users will be difficult to achieve. It is unlikely, therefore, that any audit report can itself go into sufficient detail to properly inform users.

It would be feasible, however, to use the report to explain why the auditor has arrived at a particular opinion.

Providing information regarding the audit approach tailored to the company could be part of the auditors reporting to the stakeholders. How to implement this could be further explored with relevant stakeholder groups.



European Federation of Accountants and Auditors for SMEs

Auditor Commentary

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?

Please refer to our general remarks above.

We agree with the IAASB's position that Auditor Commentary should be relevant and understandable to achieve its objective of providing value to all users. However, we believe that the auditor should not be the original provider of information as that is the responsibility of management. Management, perhaps together with Those Charged with Governance ("TCWG"), is responsible for the preparation and the fair presentation of the financial statements and the auditor is responsible for expressing an opinion thereon. Auditors should only be reporting on things explicitly required of them as laid down in the ISAs – what the significant risks were and what had been done about them and (rarely) any other matters where there had been difficulty with the conduct of the audit.

Management consequently should provide sufficient information to help users better navigate complex financial reports and focus on important matters. The auditor would draw users' attention, when necessary in the auditor's judgement, by way of clear additional communication in the auditor's report based on the current concept of Emphasis of Matter ("EOM") and Other Matters ("OM"). On this basis we support the IAASB in that Auditor Commentary should be required for auditors of PIEs although we call for careful consideration of the definition of PIE in this regard, such that it would apply to only listed entities for example, and not seek to include SMEs.

Furthermore, there are dangers that Auditor Commentary may reduce the communication value of the report and one example may be that where the Auditor Commentary obscures an emphasis of matter.

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?

Different users will call for different information that may have the most value for them. It will therefore be important to give guidance to auditors on what is expected of the auditor by standard setters after discussion with users and consideration of what the users' expectations are. Within these limits auditor judgement is the correct determinant of inclusion. This will eventually be informed by developing practice (there is none at present) and in the first instance the issue of extensive guidance and examples will be needed.

Guidance should also address the interaction between the quality of management's disclosures and Auditor Commentary. If management describes the relevant information in a fluent and transparent manner, the Auditor Commentary can be concise. Indeed, if voluminous commentary is necessary the auditor will be prompted to consider whether this affects the audit opinion.



European Federation of Accountants and Auditors for SMEs

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?

The question is a difficult one to answer. We say this because there are many different users of financial statements and it is hard to place oneself in the position where all the needs of the diverse range of users are met in terms of having relevant information provided.

The real question may well be what the Auditor Commentary is hoping to achieve. Is it attempting to give stakeholders further information – which in any case is arguably best done by management or TCWG or is it a demonstration of the thought processes of the auditor and the conclusions reached to the key audit risk areas? What it must not do is unintentionally enhance the scope of the audit; it must embody the requirements in the ISAs.

Some SME users, for instance, may be particularly interested in the recoverability of trade debts but the auditor may have judged that this is not an area likely to result in material misstatement. In this scenario, no other information would be provided. So whilst we accept that the objective of this project in conjunction with other projects should be to improve users' ability to make better informed decisions, satisfaction of this objective will necessitate a full analysis and identification of user needs. We believe that further work could still be done in this area.

Specific comments on the illustrative examples

In the section entitled "Valuation of Financial Instruments" the reason for highlighting the area is not clear. Would users conclude that management was not able to either disclose the issue transparently in the financial statements or explain the soundness of its estimates and / or valuations to the auditor? Or could users conclude that the auditor lacks the required competence or knowledge, or appears to distrust management irrespective of how sound the disclosures included in the financial statements were, or how sincere management's explanation to the auditor was? It is of value to be explicit in this regard.

In the case of "Audit Strategy Relating to the Recording of Revenue, Accounts Receivable, and Cash Receipts" the fact that the auditor would consider this a key audit issue is perhaps obvious. The narrative lacks an example, a conclusion and arguably adds no value for the given user and should therefore be deleted.

It also appears in this example that the auditor is the only source of the statement on changes in the entity's administrative practice and this should not be the case. We believe that the communication for auditors is adequately governed by ISA 260 (Communication with Those Charged with Governance) and ISA 265 (Communicating Deficiencies in Internal Control to Those Charged with Governance and Management). It is for TCWG to provide necessary information to investors and other interested stakeholders. We are not convinced that the auditor would always be best placed to do this.

In terms of all the examples we would assert that they are most likely fitting to a specific sector, in this case PIEs, and it is human nature to follow 'examples' such that they end up becoming the standard.

Finally we would caution whether explaining what the auditor has done narrows the expectations gap, if the user thinks that something else should have been done.



European Federation of Accountants and Auditors for SMEs

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?

One of the results may be a general improvement in the way in which financial statements are presented. TCWG may feel that a failure to be transparent and fluent in the presentation would result in the auditor including certain matters in the Auditor Commentary and thus be moved to be more transparent in their presentation. This would be a positive consequence.

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

We do not believe that Auditor Commentary should be mandated for SMEs (including small PIEs) but welcome its use on a voluntary basis if the auditor feels that this is appropriate. This is because there is a cost (both financial and time) to the provision of additional information for an SME with little value being provided to the users in an SME context. In many instances the users of SMEs accounts will also be TCWG.

This cost / value evaluation is perhaps more difficult in the SME arena because it is often the case that users of audited SME financial statements have the ability (because of the nature or their relationship with the entity) to obtain the information that they require, whether or not this is included within the audited financial statements.

Going Concern / Other information

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?

The proposed IAASB approach to reporting, which is based on a conclusion directed at management's use of the going concern assumption, is reasonable. We are less convinced that the "opinion" on going concern requires separate identification as it could be included prominently in Auditor Commentary.

However, it is important to note that there is a danger of increasing the expectations gap, if users discern that the auditor is doing more than management in relation to the assessment of going concern. Such a view is unlikely to be taken by investors and financial analysts but the less sophisticated users of SME financial statements may require more in the way of explanatory material and this should be recognised in the proposals.



European Federation of Accountants and Auditors for SMEs

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?

We believe that the conclusion directed at management’s use of the going concern assumption is sufficient. If the auditor has considered that management’s assumptions on going concern appear reasonable then we would question whether further information should be given.

10. What are your views on the value and impediments of the suggested auditor statement in relation to other information?

The similarities between the approach to “other information” and “going concern” are clear and so to that end it would be beneficial for auditors to indicate the precise scope of their responsibilities regarding “other information”.

This is particularly important given that some jurisdictions require certain “other information” to be disclosed and therefore any approach needs to be sufficiently flexible to accommodate such differences.

We think that until the revision of ISA 720 (The Auditor’s Responsibilities Relating To Other Information In Documents Containing Audited Financial Statements) is complete it would be premature to suggest the form of an appropriate statement. What we can say is that we feel it is of importance for the auditor to establish in his report exactly what his responsibilities are in relation to this “other information” so that users can identify the scope rather than to instead suggest wording that will ultimately become boilerplate in nature. It is of benefit for users to have some sense of whether the “other information” is consistent with the audited financial statements.

Clarifications and Transparency

11. Do you believe the enhanced descriptions of the responsibilities of management, TCWG, and the auditor in the illustrative auditor’s report are helpful to users’ understanding of the nature and scope of an audit? Why or why not? Do you have suggestions for other improvements to the description of the auditor’s responsibilities?

The earlier consultation paper reported the outcome of academic research on the usefulness of the generically-worded paragraphs. We believe that the report of the auditor can best add to user understanding by setting out clearly the scope of the auditor’s work. This, we feel, is a better direction for development of generically-worded paragraphs than, for example, incorporating the whole of the matters referred to as comprising the premise on which the audit is conducted.

12. What are your views on the value and impediments of disclosing the name of the engagement partner?

We have no strong views on whether the name of the engagement partner should be required to be disclosed, particularly as many jurisdictions already require that this is done and in fact users may wish to know who was ultimately in charge of the audit.

That said, there is no evidence to suggest that naming the engagement partner produces an increase in audit quality and in fact such disclosures may increase the liability risk. It may also mislead the reader to believe



European Federation of Accountants and Auditors for SMEs

that one person is responsible when in fact audit tends to require an engagement team even in the smallest of audit firms. Additionally, it may lead to the persons named facing other difficulties, for example ‘league tables’ of apparent performance, or targeting by special interest groups (e.g. UK case involving animal rights activists).

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?

We feel that there should be no such disclosure as it may imply sharing of responsibility when ultimately there is none.

14. What are your views on explicitly allowing the standardized material describing the auditor’s responsibilities to be relocated to a website of the appropriate authority, or to an appendix to the auditor’s report?

We agree with this approach. Such information has been successfully provided on web sites already in some jurisdictions. Such placement, appropriately referenced, would allow the detailed technical information to be provided online to those users who wish to read it while maintaining the brevity of the auditor’s report. Alternatively, it could be provided in an appendix since (even today) not every user would have readily available access to the internet.

We do believe however that TCWG and the auditor are best placed (through discussion) to judge where this information should be placed to best meet user needs. This is particularly important for SMEs because, in the absence of extended Auditor Commentary, standardised material takes up a disproportionately large part of the auditor’s report. The decision needs careful consideration because users may prefer to have an audit report for an SME in one place but draw adverse conclusions about the value of the audit when faced with extensive standardised material.

As a final test we feel that the audit report should be capable of outlining the auditor’s responsibilities and actions but not be so unwieldy that it will not be read.

Form and structure

15. What are your views on whether the IAASB’s suggested structure of the illustrative report, including placement of the auditor’s opinion and the Auditor Commentary section towards the beginning of the report, gives appropriate emphasis to matters of most importance to users?

We support the opinion paragraph being provided first which gives it the emphasis that it deserves. The order of the other paragraphs appears reasonable.

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?

We believe that the building block approach is suitable and will allow for the necessary consistency of the report across jurisdictions enabling national differences or entity specific differences to be accommodated.



European Federation of Accountants and Auditors for SMEs

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?

We think the proposed ordering is acceptable and should be mandated as outlined, unless otherwise required by national law or regulation. If we believe that the user of the auditor's report is primarily interested in the opinion paragraph then placing it first improves the report.

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?

In conclusion we do not believe that Auditor Commentary should be mandated for SMEs as it is potentially costly and time consuming but the ability of the auditor to incorporate this, if it so chooses, and if circumstances require, is of value. In general we believe that it would be a major burden on SMEs and the users of audited reports if those audit reports deemed suitable for PIEs were to be decided to be the standard for all entities.

The reasoning behind this is because across the board changes fall more heavily on SMEs and the resulting costs and benefits are not the same for all types of entities.

The perceived incremental audit cost (of identifying and agreeing the content of the Auditor Commentary with management / TCWG) when balanced within the constraints of audit liability is also of importance. In particular, for SMEs, it is likely that there is a mismatch between to whom the report is addressed (i.e. the members) and the target of the additional information. It is likely that TCWG (as shareholders) are the primary users of the audit report but SME stakeholders, such as banks are often able to obtain information from the entity regardless of whether this is shown in the audit report.

Finally, as previously stated, many SMEs are exempt from statutory audit but nevertheless commission an audit voluntarily and this circumstance should be recognised in drafting the proposals as such engagements have many special characteristics.

Other comments

Practical aspects, including any challenges of implementing the IAASB's suggested improvements to Auditor Reporting

The ability to retain entity specific information when history shows that over time this information often becomes boilerplate in nature will be critical to the success of this project and guidance will therefore be of value. Stakeholders want auditors to move away from just boilerplate language and whilst this commentary should help, it will be interesting to see the consistency in approach when dealing with fundamental issues like going concern.

There is a clear and continual conflict between users, who will always want additional information to be provided and preparers, who will want to provide less. More research could be performed to identify which users want more information and for what purposes. That said, we are supportive of the IAASB's actions to date and are aware of the inherent difficulties of research into user needs.



European Federation of Accountants and Auditors for SMEs

There will be a challenge for SMPs to explain to SMEs what this project is trying to achieve as they may not perceive the benefit of them giving more entity specific information when weighed against the cost of this process. The cost / benefit analysis for SMEs, whilst difficult to assess as a whole, should be performed.

Potential challenges of the suggested improvements in terms of the preparer's financial statements and their interaction with the auditors

EFAA's members are both preparers and auditors of financial statements. In this respect, we do not see any significant challenges other than the way in which the resulting potential changes to Auditor Reporting from the IAASB's project are communicated to the wider public.

Less experienced readers of audit reports (of which there are many outside the PIE sphere) may consider that the increased narrative and the elaborated reference to certain items included in the Audit Report actually highlights an audit issue and is not simply "setting the scene" or providing a road map to the financial statements (which is not the responsibility of the audit report). Without the required level of promotion and publicity (that states to the contrary) it may be that the simple analogy of an audit being a "pass / fail" is further muddled.

I trust that the above is comprehensive but should you have any questions on our comments, please do not hesitate to contact me.

Yours faithfully,

Federico Diomeda
Chief Executive Officer