

September 13, 2012

Via website posting: <http://www.iaasb.org/>

Re: Invitation to Comment: **Improving The Auditor's Report**

Dear Sir/Madam:

The Certified General Accountants Association of Canada (CGA-Canada) welcomes the opportunity to comment on the Invitation to Comment: **Improving The Auditor's Report**. We have also provided additional comments on certain related matters. This response is a further progression of our earlier response to the Consultation Paper: *Enhancing the Value of Auditor Reporting: Exploring Options for Change*.

Overall Considerations

Question 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?

Answer

CGA-Canada commends efforts by the IAASB for improving the auditor's report. We note the intention of the IAASB to bridge the information gap and the expectation gap that is currently experienced by users of the auditor's report. We do acknowledge the reality of these gaps and the need to explore prospective improvements. We do assert, however, that any actions taken will be judged by their end results or outcomes, and not solely by their intentions. As such, we do have major hesitation regarding the conceptual underpinning of this exercise by IAASB.

Information Gap

“The public have an insatiable curiosity to know everything except what is worth knowing”

Oscar Wilde

In short, we are skeptical about the conventional wisdom that more information represents better information, and are concerned about the intensifying obsession with knowing more about less. We believe that beyond a reasonable threshold (*optimum* versus *maximum*), information overload obeys the law of **negative** returns and is counterproductive. Moreover, numerous studies in such diverse fields as betting, investing and medical diagnosis reveal that, as the available information escalates, it increases the **confidence** of the decision makers but not the **accuracy** of their decisions. In the following paragraphs, we refer to the experimental studies that validate our premise.

In a study¹ by Dijksterhuis *et al* (2006), it was demonstrated that the study participants made a correct choice of a vehicle when they were presented with four attributes of each vehicle (low load) in a fleet, relative to when they were presented with twelve attributes (high load) of each vehicle in the same fleet. However, they were more confident of their choices in the latter case than in the former!

In another study² on medical diagnosis of myocardial infarction, it was found that the higher the level of physician's expertise, the less information was needed to make an accurate diagnosis. The experts focused exclusively on MI risks, unlike medical students who focused on both MI risks and extraneous information such as Coronary Artery Disease (CAD) probability.

These and other similar studies point to the cognitive upper bounds of the human brain and the logical conclusion that it may be superior to exploit the natural endowment of the human brain and to focus only on what is really important.

Accordingly, we believe that the interests of users will be better served by timely, reliable and relevant information that can lead to superior interpretation and insights, rather than information overload that can unintentionally serve to obscure the real issues.

Expectation gap

We believe that the expectation gap may at least, in part, result from misperceptions among users regarding the methodology and inherent limitations of auditing procedures and protocols. That is, while auditors can be mindful of the marginal utility of information, the users of financial information should concurrently be oriented to better understand the audit product, recognizing that the **absence of evidence** is not **evidence of absence**.

We contend that the proposals in this ITC superimpose the role of a financial analyst onto the auditor; impacting the auditor's objectivity as well as independence. We are also concerned that there may be confidentiality or liability implications for the auditors as a result of providing commentary that includes reference to matters not disclosed by management. In such instances, the users are more likely to be perplexed than enlightened, because of the separate disclosures by the auditor and management. We believe that one of the unintended consequences of proposed changes will be to increase, rather than diminish, the expectation gap.

In this context, we contemplate that the IAASB's suggested improvements to the auditor's report do not necessarily satisfy the test of relative value and impediments. We have, nevertheless, responded to the other specific questions in this ITC without prejudice to the above.

Question 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.

Answer

We believe that it is desirable to consider alternative strategies for improving the auditor's report. These could include:

- Strengthening and clearly articulating the conceptual foundation of auditing and assurance services;

¹ Dijksterhuis, A., Bos, M.W., Nordgren, L.F., & van Baaren, R.B. (2006). *On making the right choice: The deliberation-without-attention effect*. *Science*, 311, 1005-1007.

² Reyna V.F. and Lyoid F.(2006) *Physician decision making and cardiac risk: Effects of knowledge, risk perception, risk tolerance and fuzzy processing*, *Journal of Experimental Psychology : Applied*, 12,179-195

- Emphasizing *quality* over *quantity* of information conveyed by the auditor's report³;
- Achieving a fine balance between the financial and non-financial information conveyed by the auditor's report, and also providing information that adds real value for the users while not presenting serious impediment or cost;
- Incorporating stress tests and sensitivity analysis to external variables as a standard procedure for validating the going concern assumption;
- Structuring and continuously evolving the clarified ISAs, as per evidence-based best practices, and aligning them with present-day business dynamics and the economic environment; and,
- Deliberately educating the users on the methodology and understood limitations of auditing procedures.

Auditor Commentary

Question 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.)

Answer

We believe that the concept of Auditor Commentary is not an appropriate response to the call for auditors to provide more information to users through the auditor's report. In addition to our submissions in response to the Question 1, we further hypothesize that the users' demand for information is not uniform. The current provisions under ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* are sufficient to deal with instances when the users can be reasonably expected to benefit from the additional information in the auditor's report.

We are concerned that, with the passage of time, the Auditor's Commentary will degenerate into a standardized and boilerplate narration, and not serve to help users. The users are entirely focused on the future prospects while the auditor's focus is entirely on past performance and, hence, the Auditor's Commentary may not be as timely and relevant as other sources of information, such as management's commentary and earnings guidance. We also do not envisage any scope for providing assurance on forward looking financial projections or similar information.

Question 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.)

Answer

Without prejudice to the above, we believe that it would be logical to rely on the judgment of the auditor regarding matters to be addressed in the Auditor Commentary. However, we believe that providing detailed guidance in the standards to inform the auditor's judgment will result in transition towards a

³ Keller, Kevin Lane & Staelin, Richard, September 1987. *Effects of Quality and Quantity of Information on Decision Effectiveness*. Journal of Consumer Research, University of Chicago Press, vol. 14(2), pages 200-213

rules-based auditing regime. We are also unsure if it is appropriate for the auditor to further comment on management's judgments which is already in compliance with the applicable financial reporting framework. We also believe that the Auditor Commentary will add modest value if it serves simply to restate the disclosures already made elsewhere. In the end, the Auditor Commentary is subject to becoming redundant.

Question 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.)

Answer

Our observations on the illustrative examples of Auditor Commentary are as follows:

Outstanding Litigation

We note that this paragraph refers to a disclosure already made in the financial statements. If the auditor considers this note to be critical, it would be better to emphasize it by the use of bold fonts instead of repeating the same in the Auditor Commentary.

Goodwill

We note that this paragraph summarizes the key points regarding disclosures in the financial statements and other information. Our observations are the same as in case of the first example, and we are also concerned that reiterating the same information already disclosed elsewhere is likely to puzzle the users.

Financial Instruments

We note that this paragraph combines a reference to the financial statement disclosures with a description of certain audit procedures and a conclusion. We gain the impression that this paragraph bears a resemblance to a boilerplate narration and, hence, is not likely to add any value to the understanding of the users.

Recording of revenue, accounts receivable, cash receipts and involvement of other auditors

We note that the last two examples focus on overall audit **strategies**. We believe that such description of auditing procedures is more in the nature of **noise** than a **signal**, and obscures issues critical to understanding of the financial statements.

Accordingly, we conclude, in concurrence with our earlier submissions, that the concept of Auditor Commentary is neither conceptually sound nor pragmatic.

Question 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.)

Answer

We believe that as a result of including Auditor Commentary in the auditor's report, the aggregate cost of financial reporting for the entities will increase significantly, while the timeliness of the release of

financial statements will be adversely impacted. There may also be increased misperception regarding the roles of the management, TCWG and the auditor. Concurrently, increased rigidities could be experienced between the parties with little significant benefit materializing from the inclusion of the Auditor's Commentary in the auditor's report.

Question 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? (See paragraphs 51–56.)

Answer

On account of our above-mentioned reservations regarding the proposal for providing Auditor Commentary even for PIEs, it is our natural inclination to favor leaving its inclusion to the discretion of the auditor for other audits. However, we believe that the cost benefit analysis of providing Auditor Commentary for other entities will not justify its inclusion in the auditor's report.

Going Concern/Other Information

Question 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.)

Answer

We are not convinced by the rationale of the suggested auditor statements related to going concern. If the management's use of the going concern assumption is not appropriate, the auditor is bound to qualify the auditor's report accordingly. The detailed description of the auditor's work in compliance with ISA 570 *Going Concern* is not likely to be helpful to the users. We also do not believe that the auditor is in a better position, relative to the management, for identifying material uncertainty surrounding the going concern assumption because such exercise requires subjective judgments on macro-economic variables, industry dynamics and the entity's business model. Any perceived value of such auditor statements will be effectively negated by the following qualification in the auditor's report as suggested by paragraph 27 of the ITC:

“as not all future events or conditions can be predicted, the statement about the absence of material uncertainties is not a guarantee as to the entity's ability to continue as a going concern”.

We believe that widely recognized robust metric such as Altman's Z score⁴, which can be easily and objectively calculated from the available information in the audited financial statements, will be more helpful to the users in forming an informed opinion on the potential bankruptcy risk faced by an entity.

Question 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

⁴ Altman, Edward I. (September, 1968). "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy". *Journal of Finance*: 189–209

uncertainties have been identified? (See paragraphs 30–31.)

Answer

We believe that 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 is redundant with a very low value and high impediments. We believe that such superfluous statements are distracting and dilutive of the principal message conveyed by the auditor’s report.

Question 10

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

Answer

We are in general agreement with the proposals related to *Other Information* in this ITC. However, we also hope that the proposed revision of ISA 720 *The Auditor’s Responsibilities to Other Information in Documents containing Audited Financial Statements* will not unduly expand the scope of auditor’s work and responsibilities regarding *Other Information*.

Clarifications and Transparency

Question 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? (See paragraphs 81–86.)

Answer

We support the enhanced descriptions of the responsibilities of management, TCWG, and the auditor as stated in the illustrative auditor’s report, and believe that such enhanced description will lessen the expectation gap and help users’ understanding of the nature and scope of an audit. We see no impediments and some value in providing such descriptions. However, these descriptions are standardized and, hence, we favor moving such descriptive material to another location such as website of the National Standard Setter (NSS) with a reference provided in the auditor’s report. Alternatively, such descriptive material can also be moved to an appendix of the auditor’s report.

Question 12

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

Answer

We agree that disclosing the name of engagement partner will enhance the transparency of auditing process. However, since local laws and circumstance vary across jurisdictions, such requirement should be left at the discretion of the National Standard Setters.

Question 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.)

Answer

We favor disclosure regarding the involvement of other auditors in all relevant circumstances. We believe that such disclosure will enhance the transparency of auditing process and promote consistency in practice. We suggest amending ISA 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* for this purpose, and also requiring an explicit statement from the group auditor regarding the group auditor's sole responsibility for the audit. We believe that, because it is a matter of audit significance, such disclosure should be included in the auditor's report.

Question 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? (See paragraphs 83–84.)

Answer

Please refer to our response to Q 11.

Form and Structure

Question 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? (See paragraphs 17–20.)

Answer

We agree that positioning the auditor's opinion and Auditor Commentary (subject to our reservations about desirability of the Auditor Commentary) at the beginning of the report will emphasize the matters most important to users. Similarly, we agree with the proposal to position the basis of opinion consistently in close proximity to the opinion irrespective of the nature of the opinion. Including tailored and entity specific information in the report will also be valuable and relevant for the investors and other users.

We also endorse the proposal to make explicit reference to the notes which form an integral part of the financial statements and thus avoiding confusion with "other information".

Question 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.)

Answer

We consider the IAASB goal of globally consistent and comparable auditors' reports highly desirable, but are skeptical that it can be substantially achieved because of different legal and economic environments across jurisdictions and differences in entity-specific circumstances. However, we consider "building blocks" approach suggested by IAASB interesting and worth pursuing in the absence of a better alternative.

Question 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.)

Answer

We endorse such mandated ordering of items by the IAASB, subject to accommodating national reporting requirements or practices, as it promotes global consistency and comparability of the auditors' report.

Question 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.)

Answer

We have expressed our reservations on the proposal to include Auditor Commentary in the auditor's report. Subject to these reservations, we do not favor differential reporting requirements for the entities other than Public Interest Entities.

In case of SMEs, we believe that "building blocks" approach suggested by IAASB is flexible for customizing the auditor's report, as warranted by the entity-specific circumstances. Also, perception of the so called Information Gap is less pronounced in the case of SMEs.

We do not see any conceptual justification for viewing public sector and private sector entities differently. Also, the Information Gap is likely to be more pronounced in the case of the former, rather than latter, type of entities. We believe that the proposed dialogue between IAASB and INTOSAI will provide more insights on this issue and, in absence of any compelling reasons, both types of entities might be treated identically.

Additional Comments

We are encouraged by the IAASB endeavors to restore the credibility of the accounting profession damaged by the recent economic crisis. It is imperative to enhance the quality of auditor reporting to re-instate public confidence in the profession. However, in our assessment, the proposals in the present ITC carry low marginal value and high marginal impediments.

We note that the focus of the present ITC is to fill the perceived Information Gap and Expectation Gap experienced by the users. However, we believe that the economic crisis cannot be attributed to the lack of information, but to the failure to appreciate the risks of business models dependent upon extremely high leverage. The key decision-makers must employ available information for identifying material risks faced by the entities, rather than seek more and more information with diminishing and negative returns. We also believe that the quality of the auditor's report is a function of auditing procedures which can be improved by developing a sound conceptual framework. It is necessary to transform the extant ISAs to more empirically-based and complete set of guidance. For example, a dedicated ISA on sampling methodology would greatly enhance the robustness of this statistical technique used by auditors. We believe that the IAASB focus might be exclusively on improving auditing processes and educating users.

We also suggest collaboration with other organizations such as Global Reporting Initiative and the International Integrated Reporting Committee. We believe that such collaboration will create synergies

that would benefit all the stakeholders. We acknowledge that improving only auditing standards will not suffice, and that high quality accounting standards are also a precondition for adding any meaningful value to the financial reporting process.

Should you wish to discuss the contents of this comment paper or require further elaboration on any of the items presented herein, please do not hesitate to contact Kamallesh Gosalia at kgosalia@cga-canada.org or alternatively the undersigned at rlefebvre@cga-canada.org.

Sincerely,

A handwritten signature in black ink, appearing to read "R. Lefebvre". The signature is fluid and cursive, with a large initial "R" and a long, sweeping underline.

Rock Lefebvre, MBA, CFE, FCIS, FCGA
Vice-President, Research & Standards