FRC Financial Reporting Council 財務匯報局

Our ref : ORG5/IAASB/GEN/2/5
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4 October 2012

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

Dear James,

IAASB Invitation to Comment – Improving the Auditor's Report

The Financial Reporting Council (FRC) is pleased to have the opportunity to comment on the captioned Invitation to Comment (ITC).

Should you have any queries regarding this submission, please do not hesitate to contact me at pmkam@frc.org.hk.

Yours sincerely,

P.M. Kam
Chief Executive Officer

PM/fw

Encl.

Response to specific questions

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?**

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.**

   In general, the FRC is supportive of the suggested improvements to the auditor's report. However, we believe that the parties primarily responsible for the provision of information are management and those charged with governance ("TCWG"). The role of the auditors is to add credibility by providing assurance on such information.

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? (See paragraphs 35–64.)**

   The FRC appreciates the IAASB's initiative of including Auditor Commentary in the auditor's report in response to the call by users of financial statements for more pertinent information, and in view of increasingly complex financial reporting requirements. However, we are mindful that the primary objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework. Therefore, we would like to emphasize that this objective should not be undermined by the requirement to provide additional information to help users to navigate financial reports.

   We note that there are requirements in financial reporting standards requiring an entity to disclose areas of significant management judgment and sources of estimation uncertainty, as well as business risks. Since it is the role of management to provide information on significant matters relating to an entity, and the responsibility of TCWG to oversee the entity's financial reporting process, we have concerns that the proposed Auditor Commentary might be seen as shifting the responsibilities of management and TCWG to the auditor. We encourage the IAASB to engage other stakeholders, such as International Organization of Securities Commissions, to enhance corporate governance reporting. Certain areas included in paragraph 45 of the ITC, e.g. areas of significant judgment, significant or unusual transactions and significant matters relating to the entity, might perhaps be included in a report provided by TCWG. The auditor would then report on it, together with other issues related to the audit. We consider this has the benefit of satisfying the information needs of users of financial statements whilst not obscuring key messages of the auditor.

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.)**

As the overarching objective of the new Auditor Commentary section in the auditor's report is to provide transparency about matters that are, in the auditor's judgment, likely to be most important to users' understanding of the audited financial statements or audit, we agree that matters to be addressed in Auditor Commentary should be left to the judgment of the auditor. We expect that, without sufficient guidance in the standard, it might result in diversity in disclosures as judgments vary among auditors. It is also important to note that the purpose of Auditor Commentary is to draw users' attention to those areas which, in the auditor's judgment, are important to their understanding of the financial statements, but is not intended to criticize the quality of management's judgment.

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 general, we find the Auditor Commentary informative. However, we have reservations on the inclusion of a description of audit procedures and related results in Auditor Commentary. We share the view included in paragraph 59 of the ITC that it might be difficult to summarize the auditor's procedures, particular in complex areas, in a succinct way that reflects the extent of the underlying work and the significant judgments involved.

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.)**

We expect that the inclusion of Auditor Commentary in the auditor's report might undermine the roles of management and TCWG. It will inevitably result in additional time incurred by management, TCWG and auditors, and hence increase in costs.

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.)**

While we agree that the inclusion of Auditor Commentary enhances the transparency about matters relating to the audited financial statements and the audit, and is definitely helpful to users of financial statements, we believe the costs of requiring the same information for audits of financial statements of entities other than listed and larger entities might outweigh its benefits. We are of the view that for smaller entities, users of financial statements often have the ability to obtain additional information from management if such information is needed. The IAASB may consider encouraging, instead of requiring, entities other than listed and larger entities to provide Auditor Commentary.

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? (See paragraphs 24–34.)

As a general principle, management is responsible for the preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework, and the assessment of the entity's ability to continue as a going concern. The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. We believe that a conclusion regarding the appropriateness of management's use of the going concern assumption, and a statement regarding whether material uncertainties have been identified, are appropriate.

Nevertheless, to avoid giving a perception that the auditor is assuming the responsibilities of management by making explicit statements related to going concern in the auditor's report, we suggest similar disclosures, preferably supported with details of uncertainties and mitigating factors, should be made in the financial statements or documents containing audited financial statements. We encourage the IAASB to engage International Accounting Standards Board to consider requiring an entity to disclose, in the financial statements, management's assessment of an entity's ability to continue as a going concern, and a statement on the appropriateness of the adoption of going concern in preparing the financial statements. Requiring disclosure by the auditor alone might diminish the IAASB's objective of enhancing the overall understanding of the financial statements, and blur the distinction between the respective responsibilities of auditor and management.

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 are supportive of the inclusion of additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statements that no material uncertainties have been identified. However, in the situation set out in paragraph 30 of the ITC, certain events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, but the auditor may have determined that no material uncertainty exists based on additional information provided by the management; we believe that, in that situation, such information should be disclosed in the financial statements or documents containing audited financial statements, rather than in the auditor's report, as this information would be beneficial and crucial to the understanding of the financial statements. The auditor might then make reference to the information provided by the management when explaining its basis of conclusion.

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

We agree that an explicit statement reporting on whether the auditor has identified material inconsistencies between other information included in a document containing audited financial statements and the audited financial statements is helpful to users of financial statements. With the inclusion of a disclaimer stating that the auditor has not audited the other information as part of the audit of the financial statements, we do not see high impediments of the suggested statement.

<u>Clarifications and Transparency</u>

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.)

We are supportive of the enhanced descriptions of the respective responsibilities of management, TCWG and the auditor set out in the illustrative auditor's report, and we believe they are helpful to users of financial statements in understanding the nature and scope of an audit. However, the extended description on auditor's responsibilities appears to be out of proportion in comparison with the respective responsibilities of management and TCWG. We believe it is desirable to expand the latter to give balanced views as to their roles in the financial reporting process and corporate governance.

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

We agree that disclosing the name of the engagement partner increases transparency and accountability. It is worth noting that, while the engagement partner is primarily responsible for the conduct of an audit, the audit conclusion is typically a collective judgment of various parties. The conduct of an audit is a shared responsibility and the engagement partner follows the methodology, processes and procedures developed by the firm. In addition, certain audit procedures may be undertaken by other firms, either affiliated or which have no affiliation to the audit firm. This situation is very common if the audited entity has multinational businesses. We share the view that there could be unintended consequences of increasing the legal liabilities for the engagement partner if his or her name is disclosed in the auditor report.

While we do not have strong opposition to the disclosure of the name of the engagement partner in the auditor's report, we have doubt as to the actual value, rather than the perceived value, of such disclosure. If the IAASB determines that the merits of this disclosure outweigh its disadvantages, we suggest that instead of making it a mandatory disclosure, this should be left to the discretion of national standard setters.

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 do not oppose requiring the disclosure of the involvement of other auditors. However, this information should be restricted to significant components that are identified due to their individual financial significance to the group, or because they are likely to include significant risks of material misstatement of the group financial statements; thus avoiding unduly lengthening of the auditor's report. Since the group engagement partner is responsible for the identification of significant components, we therefore believe that such a disclosure should be left to the auditor's judgment as part of Auditor Commentary.

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.)**

We wish to express serious concern at allowing the standardized material describing the auditor's responsibilities to be relocated in a place not within the auditor's report. We welcome the IAASB's proposal of expanding the description of the auditor's responsibilities, as it is crucial for users of financial statements to fully understand the concept of a risk-based audit. However, relocating this information outside the auditor's report might undermine the IAASB's overall objective of enhancing the communicative value of auditor reporting, and might widen the expectation gap between users of financial statements and auditors.

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? (See paragraphs 17–20.)**

We agree that placing the auditor's opinion and the Auditor Commentary section at the beginning of the auditor's report would give appropriate emphasis to matters of most importance to users of financial statements. However, we have concerns that moving the section of respective responsibilities of management and the auditors towards the end of the report might not gives enough prominence to enable users of financial statements to appreciate the respective responsibilities of auditor and management; the proposed structure of the auditor's report might have an inadvertent consequence that the report is not read in full, and hence there is a possibility of widening the expectation gap.

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 are of the view that it is highly desirable to achieve global consistency in the structure of auditors' reports, as it promotes comparability and facilitates understanding of auditors' reports and cross-border business activities. With standardized reports, unusual circumstances would be easily identified by users of financial statements.

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.)**

We are in support of the IAASB's proposal to mandate the ordering of items as shown in the illustrative report across entities and jurisdictions, unless law or regulation require otherwise. We believe that it helps users of financial statements navigate the auditor's report, and promotes comparability. We are of the view that the proposed structure provides sufficient flexibility to accommodate national reporting requirements.

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.)**

While the suggested improvements enhance the communicative value and transparency about the audit, we believe that they should be introduced for listed and larger entities at least at the initial stage. The IAASB may encourage public sector entities, if they are not listed, to provide the additional information. We believe that for smaller entities, users of financial statements often have the ability to obtain additional information if such information is needed. The costs of additional auditor reporting may outweigh its benefits.