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Ref: DAH

27 November 2013

Mr James Gunn  
Technical Directors  
International Auditing and Assurance Standards Board

By email: jamesgunn.iaasb.org

Dear Mr Gunn

**EXPOSURE DRAFT - REPORTING ON AUDITED FINANCIAL STATEMENTS: PROPOSED NEW AND REVISED INTERNATIONAL STANDARDS ON AUDITING (ISAS)**

Thank you for the opportunity to provide comments on this exposure draft.

Pitcher Partners is an association of independent firms operating from all major cities in Australia. Our clients come from a wide range of industries and include listed and non-listed disclosing entities, large private businesses, family groups, government entities, small to medium sized enterprises and not-for-profit entities. Consequently we provide audit and assurance services to a wide range of business structures and issue auditors' reports which are used by a broad range of stakeholders ranging from largely anonymous groups of investors in capital markets, to clearly identifiable and mainly closed groups of private investors and other stakeholders in the non-listed market.

We acknowledge that in developing the exposure draft, the IAASB has incorporated many of the recommendations put forward by respondents on the "Invitation to Comment: Improving the Auditor's Report" issued by the IAASB in 2012. Consequently, at least in theory, preparation of a long-form auditor's report, in accordance with proposals in the exposure draft, appear reasonable and achievable.

However, as we have attempted to field test these proposals, we have encountered unexpected difficulties that are explained in our comments below. Overall we consider that while the proposed reporting requirements may have far-reaching consequences for audit services and the audit profession, they seem to have aroused little evidence of user demand. We strongly recommend that the IAASB conducts appropriate research to demonstrate the anticipated benefits of the auditor reporting proposals before mandating the significant changes described in the exposure draft.

## Responses to Specific Questions re Key Audit Matters (KAMs)

1. *Do users of the audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?*

We have not received any conclusive feedback regarding whether or not this information would be useful to users; the most frequent response has been to ask *why* auditors would include this information in the auditor's report.

Our general discussions with directors in respect of the principle that KAMs should be reported in the auditor's report has returned concerns that it should be the directors, and not the auditor, who inform the market about issues in relation to the preparation and presentation of the financial report. In some jurisdictions, directors provide a commentary on these issues. We note that the UK Corporate Governance Code revised in October 2012 includes new requirements for audit committees to describe in more detail the work that they do and to disclose significant issues they have considered in relation to the financial statements and how they were addressed. We consider that it would be far more appropriate for the auditor to comment on KAMs if or when the company has the primary obligation to report on these issues. Based on the guidance in the exposure draft we are uncertain as to the differences (if any) between issues that impact *preparation* of the financial statements, and issues that impact the audit per se. (Refer examples in relation to *accounting* issues under Q4 below).

In the absence of directors' (or audit committee) responsibilities to report on matters that impact preparation of the financial statements, we can envisage the situation where reporting of KAMs becomes a key consideration in audit tenders and replacement of auditors. We are concerned that such pressures will not promote audit quality or better information in the auditor's report.

2. *Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor's judgment in determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?*

We consider that it will be a relatively straightforward process to *identify* KAMs to include in the auditor's report **when** there are significant events or transactions that are not in the ordinary course of business, and/or which are based on critical estimates or judgments, and/or where there is uncertainty. However, we are concerned as to the auditor's ability to 'condense' reporting of such issues to a single paragraph or two in the auditor's report, and particularly where these items may have been subject to extensive discussion and debate with experts and/or the audit committee.

We are also concerned that it will be extremely difficult to identify KAMs to report when a company does **not** have significant events or transactions outside the ordinary course of business, or *no* recognition and measurement of such items that involve critical accounting estimates and judgements, or when the financial statements are largely based on historical costs and there is minimal uncertainty. We consider that in these circumstances the nature of items included as KAMs are likely to be both inconsistent and diverse.

3. *Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor's report? If not, why?*

The requirements in proposed ISA 701 and related guidance effectively scope the issues to be considered for inclusion in the auditor's report as the matters communicated with those charged with governance. Auditors are experienced in preparing reports for audit committees or boards, and therefore this point of reference is useful for identifying 'the boundaries' regarding the items that are likely to be communicated in this section of the auditor's report.

However, we anticipate there will be significant difficulty and inconsistencies in identifying items to communicate when there are **no** significant matters outside the ordinary course of business or if there are limited areas of subjectivity or uncertainty in measurement and recognition of elements of the financial statements. This was our experience in our attempted field testing, which is explained further under Q6 below.

4. *Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking in informational value, and why? Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.*

Although the theory regarding communication seems reasonable, and the matters communicated to those charged with governance (TCWG) appears to be a reasonable starting point, the actual disclosures provided are somewhat superficial and lack real meaning. We also consider that the matters raised are *accounting issues* rather than *audit issues*. Matters communicated to TCWG are often summarised in presentation slides, but any issue of substance will be discussed at length. Using Illustration 1 in the Appendix to proposed ISA 700 as an example:

*Valuation of financial instruments:* the accounting standards contain extensive requirements for identifying circumstances when an entity-developed valuation model may be used. These models would be classified as Level 3 in the fair value hierarchy. The accounting standard methodology requires that Level 1 or Level 2 fair value measurements are used when available, in preference to level 3 measurements. Disclosure requirements for level 1, level 2 or level 3 fair value measurements explicitly recognise that there is increasing measurement uncertainty at each level. The accounting standards require the underlying assumptions to be evaluated and disclosed. Discussion with TCWG (or more likely the expert providing the valuation) would be extensive – not simply to test the model used, but also to consider alternative valuation models that *could* have been used, and then testing the assumptions for each possible model.

Consequently, the disclosure of this KAM states no new information. The same information could be provided by providing an emphasis of matter paragraph which states:

"We draw attention to note X in the financial statements which describes the measurement methodology for level 3 financial instruments."

If the measurement model had not been appropriate, or if the auditor did not concur with the assumptions used in the model, including the need to include a sensitivity analysis in the disclosure notes, a qualification would have been needed. We consider that these are accounting issues rather than audit issues. An audit issue would arise if there were no underlying systems and processes to support the information needed as input to the valuation model, or if there were difficulties in testing those systems.

*Revenue Recognition Relating to Long-Term Contracts:* this disclosure is somewhat more meaningful as the proposed revised accounting standard that contemplates the issues described, has not yet been issued. Consequently, if there is an emerging accounting issue, then the additional audit disclosure may provide useful information, albeit that the auditor would expect to see the accounting policy adopted in these circumstances clearly explained in the accounting policy notes. Under the current reporting regime, an emphasis of matter paragraph would bring attention to this issue if it was deemed necessary.

However, if the proposed “Revenue from contracts with customers” accounting standard had been issued (with requirements as anticipated) then issues relating to variation of contract terms (apparently referred to here as ‘side agreements’) would have been addressed in the accounting procedures. Again, if these accounting procedures had not been followed, the auditor would need to qualify for non-compliance with the accounting standard.

5. *Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why? Are there other practical considerations that may affect the auditor’s ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?*

We consider that a decision to communicate KAMs, when there is no requirement to do so, should always be discussed with TCWG and should be communicated in the engagement letter prior to commencement of the audit. From a practice risk management perspective, we would always follow authoritative material for conducting a voluntary procedure, where there is authoritative material that relates to the topic at hand.

However, we have concerns regarding consequences at the end of the audit, in the event that TCWG no longer wish to have the KAMs disclosed and wish to vary the terms of the engagement in the final stages. With this possibility in mind, we expect that arrangements to communicate KAMs to TCWG will remain private reporting arrangements (albeit in accordance with the proposed ISA 701) unless they are mandated. In these arrangements we would expect the auditor to attempt to condense the matters discussed with TCWG into a limited number of paragraphs, to demonstrate the likely form and content of the KAMs that would have been disclosed if the practice had been mandated.

We consider that there is a serious risk that time previously spent in broader discussions of observations and matters arising from the audit will be diverted to time spent debating the nature of KAMs and the wording of their description. This outcome would not improve actual audit quality, but *perhaps* only the external perception of quality.

6. *Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate?*
- a) *If so, do respondents agree with the proposed requirements addressing such circumstances?*
- b) *If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor's responsibilities under proposed ISA 701 and the determination, in the auditor's professional judgment, that there are no key audit matters to communicate?*

During our attempted field testing, we selected two audit clients with strong financial track records, and non-complex operations and accounting. We considered that these two clients would provide us with a "base line" in respect of potential complexities arising in applying the new requirements. When we reviewed matters reported to the audit committee there were no significant audit issues per se. The audit committee report described observations arising during the course of the audit, which could be considered as "value-adding" or continuous improvements to the systems and processes examined. We would always report our observations in circumstances where there are no significant audit issues. It is not feasible for an auditor to provide a "no matters" report to an audit client, as there are always opportunities to further improve internal processes.

This situation led to debate about whether it was feasible to report *no issues arising* in the auditor's report, whether *something* should be included as a KAM, whether reporting or not reporting *observations* would increase practice risk, and concern regarding how the regulator may view any decision made. We suspect that the Australian regulator would wish to see any matters communicated to TCWG included as KAMs in the auditor's report. Consequently the KAMs included in the re-draft of the auditor's report for the purpose of the field testing were essentially contrived to meet a perceived requirement to report.

We have *not* discussed these revised drafts of the auditor's report with the audit client due to the potential to aggravate directors of well-managed, very successful businesses. Further, we have concerns as to whether we would be as forthright in making observations to "value-add" if these recommendations in some way contributed to perceived negative statements in the auditor's report. If the proposals become standards, we will need to closely examine our internal processes to develop protocols for streamlining the capture and consultation re KAMs to be disclosed. We will also need to devise a separate reporting mechanism for discussion of "value-add" comments and recommendations. However access to more audit committee time for discussion of non-critical issues may be difficult. (Refer to final comments under '*Anticipated benefits and costs of the proposals*').

As noted above and given the time taken to 'find' KAMs to report, we consider that there is a serious risk that time previously spent in broader discussions of observations and matters arising from the audit will be diverted to time spent finding, and then debating the nature of KAMs and the wording of their description. This outcome would not improve actual audit quality, but *perhaps* only the external perception of quality.

7. *Do respondents agree that, when comparative financial information is presented, the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?*

Perhaps due to the increasingly competitive market for audit services, we have observed that predecessor auditors are generally less willing to operate in the spirit of co-operation anticipated in professional standards, but tend to provide access to only a minimal level of prior year audit work papers. Consequently, we have serious concerns that a newly appointed auditor will have access to sufficient information to form a view on matters previously reported.

We also have concerns that inclusion of key matters relating to prior periods could contribute to ‘information overload’ and thereby reduce the useability of the auditor’s report rather than improving the quality of the information provided. Therefore we concur with the proposal that auditor communications of KAMs should be limited to the audit of the most recent financial period.

8. *Do respondents agree with the IAASB’s decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters, and how such concepts have been differentiated in the Proposed ISAs? If not, why?*

We consider that the ‘Emphasis of Matter’ paragraphs and ‘Other Matters’ paragraphs, which are used in the current auditor reporting regime, are working well. However, we do not support retention of these paragraphs if a long-form auditor’s report is introduced. We consider the subtle prioritising regarding positioning of matters in the proposed auditor’s report will cause considerable confusion to both preparers and users of the auditors’ reports.

#### **Auditor reporting on going concern**

9. *Do respondents agree with the statements included in the illustrative auditor’s reports relating to:*
- a) *The appropriateness of management’s use of the going concern basis of accounting in the preparation of the entity’s financial statements?*
  - b) *Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity’s ability to concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised))?*
- In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.*

At the two extremes of reporting for going concern (i.e. when the entity clearly *is* or *is not* a going concern) we consider that the requirements pose few problems. However, the situations that already cause significant challenge are when the circumstances in respect of going concern include varying degrees of uncertainty, with different possible chains of events that would take the entity to very different outcomes. The relative ‘seriousness’ of these going concern issues are currently signalled by the nature of the auditor’s opinion i.e. adverse, disclaimer, qualified or emphasis of matter.

Based on the proposed requirements we understand that the most serious consequences in relation to going concern issues will still be reported in the form of the opinion i.e. adverse, disclaimer or qualified. However, we are concerned that issues previously included as an ‘emphasis of matter’ may lose their impact when presented within the body of a lengthy report. Currently users can quickly navigate to those paragraphs of significance, based on



the 'shape' of the auditors' reports. The proposed long-form of the auditor's report will require users to actually *read* the auditor's report in its entirety. Although this may be a reasonable expectation, it would be useful to conduct research to determine whether this expectation has any validity.

Further, auditors' reports are not written in plain language, but rather use the language of accounting and auditing standards. This practice is necessary as the use of defined terms enables a more concise report to be drafted; this practice also reduces ambiguity in the message delivered and thereby also reduces practice risk. However, the clear meaning of the auditor's report is only apparent to those who understand the subtlety of the choice of words used. We have serious concerns that users who are not technical experts in audit and accounting may give up reading the detail when presented with pages of information.

*10. What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?*

We do not have a strong view whether or not this statement is included. We consider that there are other serious issues that would benefit from further comment.

We are concerned that auditors continue to be required to provide a true and fair view on accounting frameworks with a pervasive use of fair value measurements. The nature of fair value measurements are such that the auditor (even when using experts) is more often within the realm of "nothing has come to my attention to indicate the fair value measurements are not true and fair" rather than explicit statements of "true and fair".

While auditors do not provide reasonable assurance on prospective information, expected present value calculations for fair value measurements are largely dependent on projections of future cash flows, together with significant assumptions concerning market conditions, future growth rates, systematic and unsystematic risk and assessment of the probabilities for differing outcomes actually occurring. Auditors mitigate the risks around "true and fair" by ensuring that all relevant information supporting that fair value calculation is adequately disclosed in the notes, together with sensitivity analysis where there is a material variance if assumptions were to be varied.

Consequently, in our view, bland statements regarding going concern, or limited disclosure in KAMs (as discussed in relation to the illustrative reports above), have the potential to be superficial and misleading, unless they are carefully crafted. However, carefully crafted paragraphs are only likely to have meaning for technical experts.

***Explicit statement of auditor independence and source of ethical requirements***

*11. What are respondents' views as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?*

In addition to auditor responsibilities for compliance with ethical requirements, we consider that TCWG should be satisfied that the auditors appointed have complied with those ethical requirements. The two-way understanding of ethical requirements is the litmus test for demonstrating independence is actually achieved.

Perhaps of equal significance, auditors should have experience and expertise appropriate for the entity being audited. However, matters relating to experience, expertise, qualifications or training of auditors are taken as being implicitly understood within the ethical requirements. While we do not have a strong view as to whether or not this information is included, we consider that undue emphasis continues to be given to independence, being only one aspect of an auditor's credentials. While there is clear understanding that an auditor who is not independent is unlikely to deliver a quality audit, an independent auditor with inadequate experience, expertise, qualifications or training is also unlikely to deliver a quality audit.

***Disclosure of name of the engagement partner***

*12. What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?*

The name of the audit engagement partner is already disclosed in auditors' reports issued in Australia and therefore there will be no change here, if this requirement is introduced.

***Overall form and content of the proposed auditor's report***

*13. What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?*

We generally concur with the proposals in paragraph 102.

The paragraphs that currently describe the auditor's responsibilities in the auditor's report provide very limited information and are not written in plain language. We consider that the proposal to make references, from the auditor's report, to the website of an appropriate authority will enable a comprehensive explanation of these responsibilities to be provided, written in plain language that users can understand.

We also consider that management responsibilities and/or responsibilities of TCWG could be better explained in an appendix or referenced to an authoritative web site.

In Australia there are other reporting responsibilities (for example) on the remuneration report issued by listed companies. Consequently it is appropriate that the proposed ISA 700 should include provision for other reporting responsibilities.

*14. What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20–45 and the circumstances addressed in paragraphs 46–48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?*

We consider that in the absence of national requirements, the ordering of sections of the auditor's report should be consistent with requirements in ISA 700 to enable users to quickly navigate to the sections of interest. We do not believe that a long-form auditor's report will



assist user understanding unless users are able to locate the information they need quickly, without having to re-read the whole report each time they might wish to refer back to it.

### ***Anticipated benefits and costs of the proposals***

We consider that the proposed auditor reporting requirements will introduce considerable additional costs for the audit firm while the benefits anticipated are not entirely clear. When there are any modifications to the auditor's report under the current reporting regime, significant time is needed for internal consultations with the engagement quality control review partner (EQCR), technical and other experts, and practice risk management, and then significant further time for consultation with the client. The time taken to finalise an auditor's report is rarely recoverable in the audit fees charged.

We are also concerned as to how senior members of the audit team, including the engagement partner and EQCR, will have sufficient time when a jurisdiction (such as Australia) has a majority of companies with reporting obligations at a certain date.

For example, the majority of companies in Australia have 30 June reporting dates. Listed companies with 30 June reporting dates must announce preliminary results to the market by 31 August and lodge statutory audited financial reports by 30 September. Consequently auditors of smaller listed companies in particular, will experience increased pressure in finalising long-form reports in a short period of time. Auditors of larger listed companies are unlikely to be faced with competing demands for finalisation from several smaller listed clients. The increased time pressure will also extend to independent directors and audit committee members who are involved in detailed reviews of the financial statements, and discussion with external auditors.

In our view the proposals introduce new risks in audit quality:

- Reporting of KAMs is likely to become a key consideration in audit tenders and decisions to replace auditors;
- Significant audit resources will be diverted to time spent debating the nature of KAMs and the wording of their description both internally within the audit firm, and externally with the client;
- The use of "accounting language" and "audit language" terms and phrases in the auditor's report is likely to increase in order to provide concise explanations of matters identified; the ability of users to understand the intended meaning will be limited to those users who are technical accounting or technical audit experts;
- Time pressure on auditors, audit committees and independent directors to finalise the financial reporting process will limit the time available for broader value-adding discussions of observations and matters arising from the audit;
- The audit will become increasingly focussed on strict compliance, and opportunities for the auditor to influence governance practices, or discuss issues seen as 'non-critical' will decline;
- Audit firms will need to establish protocols to identify KAMs to be communicated and to clearly differentiate between reporting issues that represent "value-adding" comments and those that have a significant impact on the audit;
- Albeit that audit risks are currently documented and addressed through audit methodologies, the introduction of KAMs requires a further "layer" to be separately

identified; audit firms will need time to develop training materials and to amend methodologies to promote appropriate documentation of KAMs at every stage of the audit;

- Auditors with only a few listed audit clients may choose not to incur these additional costs and exit the listed company audit market; this will increase audit concentration for those firms with economies of scale that can sustain the investment needed to support increasing auditor reporting requirements.

In respect of this last point, the IAASB should consider to what extent consideration of competitive advantage might influence the responses received.

These new risks may not improve *actual* audit quality but are more likely to *decrease* actual audit quality. We consider that independent audit should be a value-adding service provided to businesses, and that reporting on the financial statements is the end product of auditing the financial reporting systems and processes. In addition to reporting on the financial statements, the audit process enables businesses to examine their governance and internal controls, and therefore is fundamentally in the public interest. The impact of audit on organisational behaviour is an essential element of audit quality, as it drives the next wave of economic prosperity in all regions of the globe. The proposals in the exposure draft concerning auditor reporting may have the inadvertent consequence of removing the auditor's ability to shape organisational behaviour and may therefore not serve the public interest.

Nonetheless we acknowledge that a long-form auditor's report *might* provide some benefit to users, if the information provided is understandable to users. Alternatively a long-form auditor's report may simply improve an external perception of audit quality. Given the seriousness of the risks identified above, and the potential for far-reaching consequences for the audit profession and on organisational behaviours, we consider that the IAASB should first conduct appropriate research into the benefits users might anticipate if a long-form auditor's report were to be introduced, and the impact of proposed changes on user perceptions of audit quality.

Please do not hesitate to contact me directly, if there are any matters arising from this submission which you would like to discuss further.

Yours sincerely



S D AZOOR HUGHES  
Partner