

October 5, 2012

IAASB Technical Director

Dear James,

Small and Medium Practices (SMP) Committee Response to the Invitation to Comment (ITC), *Improving the Auditor's Report*

Introduction

The SMP Committee is pleased to respond to the IAASB on this ITC.

The SMP Committee is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small- and medium-sized entities (SMEs). The constituents of the SMP Committee are small and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members of the SMP Committee have substantial experience within the accounting profession, especially in dealing with issues pertaining to SMEs, and are drawn from IFAC member bodies from 18 countries from all regions of the world.

Effective changes to auditor reporting can only be made with due consideration of the needs of all major stakeholders. We note that views on auditor reporting have traditionally been dominated by investors and analysts and so, in welcoming this ITC, we particularly appreciate the Board's recognition of the need to consider the users of the financial statements of SMEs.

General Comments

We believe decisions on auditor reporting and audit scope should primarily be made with regard to the public interest. This involves consideration of the costs and benefits to the public, including relative needs, costs and benefits to affected stakeholders, which in reality vary significantly across different stakeholder groups.

It is acknowledged that there are generally few types of user of audited SME financial statements, and often these users already have a relationship with the entity such that they are able to obtain the information they need, whether included in an auditor's report or not. Our concern, therefore, is that expansion of auditor reporting will make the cost/benefit relationship of SME audits even more challenging than is currently the case, and may also result in audit reports, especially for SMEs, running to excessive length.

We therefore commend the IAASB on developing a meaningful and thought-provoking ITC. We also feel the approach taken throughout the ITC is consistent with the features of proportionality generally inherent in International Standards on Auditing (ISAs), and so provides a good platform on which to develop suitably proportionate standards around auditor reporting.



Specific Comments

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?***

An optimal solution to meeting user needs can only be reached by viewing the considerations in the ITC within the broader context of financial reporting and regulatory drivers. Preparers, standard setters and regulators need to be engaged in that debate to ultimately determine what information should be provided and by whom.

We believe that investors' information needs ought to be met primarily by preparers, and that auditors cannot and should not be expected to remedy perceived shortcomings in the accounting framework by reporting through the audit report.

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

However, since many of the issues dealt with in the ITC are obviously more relevant to companies listed on major capital markets, we recognize there is potential for the needs of SMPs, SMEs and their stakeholders to be overlooked when resultant changes to auditor reporting are determined. We therefore call on the IAASB to ensure that any changes to auditor reporting are not to the detriment of smaller entities.

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.***

Please refer to our response to Q1.

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?***

We generally believe that the concept, if not all of the proposed content, of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report.

We also agree with the IAASB's position that Auditor Commentary should be relevant and understandable to achieve its objective of providing value to users, but the auditor should not be the original provider of information about the entity.

Within the constraints of not changing the audit mandate, in general the IAASB's suggested improvements appear to strike a reasonable balance.

We also acknowledge the approach taken by the IAASB that Auditor Commentary should be conceptually consistent with existing Emphasis of Matter (EOM) and Other Matter (OM)



paragraphs, but with a lower threshold for auditors to report. We also note the IAASB's preliminary view that EOM/OM should be replaced by the more holistic Auditor Commentary.

EOM/OM disclosures are important for entities of all sizes and carry impact. If the IAASB does decide to subsume EOM and OM within Auditor Commentary, then those matters currently required to be disclosed as EOM and OM should probably be mandatory components of Auditor Commentary. This would appear compatible with the principle of 'an audit is an audit', and may be an effective way of developing a proportionate solution by which all audit reports would provide the high hurdle disclosures but, under conditional requirements of a proposed standard, only PIEs would require further Auditor Commentary. Further, such an approach would result in all such disclosures being made under the heading 'Auditor Commentary', which is likely to be more meaningful to users than the more technical phrase, 'Emphasis of Matter'.

However, we recognize that users may have difficulty understanding or interpreting an audit report that contained both Auditor Commentary and EOM/OM disclosures, and that there is a significant danger that the clear signal of an EOM/OM would either be lost or heavily disguised by the presence of other commentary.

Therefore, while we do not necessarily oppose the IAASB's preliminary view, we would urge the IAASB to ensure that any solution does not result in the impact of EOM/OM becoming diluted or distorted as a consequence.

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?*

Firstly, we believe that the auditor cannot be the source of any information about the reporting entity that is not already disclosed in the financial statements, as that is the role of management and those charged with governance (TCWG). We also believe that Auditor Commentary should not result in the auditor having to perform further audit procedures than those currently required under the ISAs.

We also perceive a risk that audit commentary may be used in some circumstances as a vehicle to circumvent or water down an opinion that would otherwise be qualified under current requirements. While the solution to this may not necessarily be achieved by prescribing the required content of Auditor Commentary, we believe it is essential that any resultant standards contain clear requirements that are designed to prevent such actions.

As explained in our response to Q3, and within the caveats outlined therein, in principle we would not necessarily oppose existing requirements around EOM/OM becoming mandatory components of Auditor Commentary. Beyond this, and the positions we have set out above, there is some difference of opinion amongst the SMP Committee over the extent to which matters to be addressed in Auditor Commentary should be prescribed:

- i. The majority view of the SMP Committee is that matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, subject perhaps to allowing national standard setters to prescribe certain minimum requirements to meet local needs.



Auditor judgment in this area will, to some degree, be informed by developing practice. In the absence of any established practice, extensive guidance and examples will initially be needed (as anticipated in paragraph 47 of the ITC) in order to inform auditors what is expected of them. In particular, if 'most important to users' is to remain the determinant, then criteria will have to be provided against which the auditor can best determine which issues are included in the commentary.

Guidance will also be needed to help ensure Auditor Commentary does not become – or become perceived as – a series of piecemeal opinions or mini conclusions, which may deflect attention away from the auditor's opinion itself.

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 found to be necessary, the auditor will be prompted to consider whether this affects the audit opinion. Guidance might also suggest that the auditor considers the necessity of commenting on material areas of low risk where relevant.

- ii. In the absence of any established practice around Auditor Commentary, a minority of the SMP Committee believe the IAASB should establish clear criteria over what should be included in Auditor Commentary, whilst still leaving some flexibility for the auditor to determine the exact wording. For example, some believe there should be a minimum requirement for auditors to provide commentary on significant risks identified in the audit (with the exception of fraud risks or risks of management override, since these risks are always presumed to be significant risks). Information from the auditor in relation to these risks as well as their linkage to the financial statements may be helpful to users in their assessment of the financial statements.

The contrary view is that any change in the auditors' report which would require more detailed reporting of the auditor's assessment of risk, procedures performed, etc. may actually result in an increase in the expectation and information gaps. To a reader of an audit opinion who does not necessarily understand the requirements of auditing standards, discussion of these topics may result in their interpretation of the work performed providing a higher level of assurance than intended. Additionally, to the extent that different auditors may describe their work effort differently, readers may interpret these differences in providing varying levels of assurance when, in fact, they do not.

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 illustrative examples generally address matters unlikely to be of great relevance to users of financial statements of a typical SME. Further, users of SME financial statements are likely to be able to obtain informational or decision-making value by means other than the audit report, and often before the date on which the report is issued.



Nevertheless, as indicated in our response to Q4, we foresee situations where users may obtain value from the auditor commenting on material areas with insignificant risk, for example a large accounts receivable balance that had been received by the entity on or before the audit report date, hence no collection risk. We therefore suggest an example of such be included within the illustrative examples of Auditor Commentary.

We oppose including a description of audit procedures and related results in Auditor Commentary, for a number of reasons:

Firstly, to do so may be wrongly interpreted by users as a series of piecemeal opinions. We believe this has to be avoided. Even adding an explanation at the beginning of the Auditor Commentary section would not counteract this adequately. We also see a risk that increased elaboration of audit procedures and results may result in inappropriate levels of assurance being ascribed to them by users. Auditors could inappropriately use Auditor Commentary to promote the apparent thoroughness of their work for competitive advantage; reports could also become cluttered; and auditors working more efficiently (for example, obtaining the same quality of evidence with less work) might even be at a disadvantage.

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?*

As already mentioned, we agree with many of the respondents to the May 2011 consultation that the auditor should not be the source of original information about the entity, since the responsibility for disclosing such information rests with management and TCWG.

Beyond this, we see a number of implications for the financial reporting process of including Auditor Commentary:

- It would likely necessitate increased involvement by more experienced audit team members and partners. In an SMP environment, where such expertise may often rest in the hands of a very small number of individuals, we believe that this could be incrementally more burdensome than for larger firms, and that in most cases the burden would likely outweigh any resultant benefits to users of SME financial statements.
- It may help improve the way in which financial statements are presented, since 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. This is likely to be more of an issue amongst larger entities, where financial statement disclosures are typically more complex;
- It may affect the timing of the audit, in particular in regard to the time needed for agreeing the specific wording of the auditor's report with management or TCWG;
- It may encourage better communication generally between auditors, management and TCWG before engagement completion.

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?

Conceptually, we believe that the ability of users to obtain information over and above that in the auditor's report should be the key driver in determining requirements around Auditor Commentary, with due regard to the related costs and benefits of providing that information.

In an SME context, where users are typically few in number and generally already have access by other means to the information they need, we believe in the vast majority of cases that the costs of providing Auditor Commentary are likely to exceed the resultant benefits.

Therefore, we agree that Auditor Commentary should be mandatory for listed entities and other PIEs (criteria around the latter being determined by national standard setters, taking into consideration local environmental factors and national definitions of PIEs (which may include SMEs)), and voluntary for others¹.

In the case of voluntary Auditor Commentary, however, there is some degree of discomfort amongst a minority of the committee about the decision being left entirely to the discretion of the auditor. Some operational criteria around that, most likely in the form of application material, may therefore be desirable in order to help ensure due consideration is given to the users' needs.

Some committee members feel there is a risk that users may perceive auditor reports with no Auditor Commentary as being of secondary importance or stature to those with Auditor Commentary. Therefore, even if Auditor Commentary for smaller entities is to be voluntary, some guidance around the decision whether or not to provide Auditor Commentary may still be helpful for SMPs. Such guidance might also help firms meet the objective of ISQC 1 paragraph 11(b) that reports issued by the firm or engagement partners are appropriate in the circumstances.

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?

We are not aware of any evidence to suggest that ISA 570 is deficient and so we would oppose any requirement for the auditor to perform procedures that go beyond the current scope of the audit.

We do see value in setting out the respective responsibilities of management and the auditor within the report, as this may help narrow the expectation gap. Beyond this, however, we are concerned that mandating the suggested statements in all audit reports appears unnecessary, especially as in the majority of audits it will likely not be the most useful information auditors can communicate to users. It may also result in undue prominence being given to going concern, which may distort the reader's understanding and possibly increase the expectation gap.

¹ This position is notwithstanding our comments and caveats in response to Q3, specifically in respect of EOM/OM disclosures, regarding the possible merits of making Auditor Commentary mandatory for all entities but differentiating on the required content, based on the circumstances of the engagement.



We therefore believe it would be preferable that any statements on going concern are made only if doing so would meet the criteria advocated in the ITC for making Auditor Commentary, namely that such disclosure would, in the auditor's opinion, be of most importance to the users. A logical extension of this concept would be for the going concern statement to be incorporated within Auditor Commentary, as appropriate.

In circumstances where the auditor does decide that going concern disclosures are of most importance to users, the suggested conclusion focusing on management's use of the going concern assumption appears reasonable, and neatly complements the suggested statement of management responsibilities relating to going concern. However, we are not convinced of the need for the auditor to make a statement on material uncertainties affecting going concern, for the reasons set out in our response to Q9.

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 the costs of including such additional information in the auditor's report will generally outweigh the benefits to the user, and so we oppose the suggestion. We believe the user is most interested in whether the auditor agrees or disagrees with management's position and, where the auditor does agree, requiring additional information on the auditor's judgments and processes risks overloading or confusing the reader. Equally, if the auditor disagrees with a significant judgment then presumably a modification of the report would be required, through which the user would obtain the rationale for the auditor's opinion.

Our belief that the auditor should not be responsible for disclosing entity-specific information that has not already been disclosed by management and TCWG would, in our opinion, also impede any blanket requirement for the auditor to provide meaningful information about the underlying judgments and processes in all situations.

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

We believe it is beneficial to include a statement of auditor's responsibilities in respect of other information. We also accept that there is value for the user to understand whether the auditor concludes that the other information is consistent with the audited financial statements, whilst not having audited it.

However, until the revision of ISA 720 is complete, we believe it would be premature to definitively suggest how the statement ought to be worded.

Clarification 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?*



We appreciate the theory and logic behind the suggested enhanced descriptions but we have some concern over the resultant length of the audit report, especially as these descriptions will form a larger proportion of the audit report of a typical SME than of a larger entity.

We therefore believe that consideration should be given to condensing the responsibilities of the auditor and management to a couple of sentences that succinctly contrast the role of the auditor with that of management. This may also help guard the profession against criticism that the audit report is too defensive and overloaded with boilerplate language.

Specifically in respect of management's responsibilities, we suggest that the first sentence in this section of the example report in the ITC (*"Management is responsible for the preparation and fair presentation..... whether due to fraud or error"*) should be retained, since it is a premise for the performance of an ISA audit, regardless of management's legal responsibilities, and helps contrast the role of management from that of the auditor. Beyond that, we believe that a brief commentary that management is responsible for the disclosures related to the going concern assumption is all that would need to be mandated.

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

From an SMP perspective, we are neutral on this issue.

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 oppose the suggested disclosure as we believe it runs contrary to the "sole responsibility" principle of ISA 600. Furthermore, we see little value to the users of SME group financial statements of making such disclosure.

We are also concerned that disclosing the names of other auditors may have negative unintended consequences. For example, in instances where the other auditors are part of the same network or affiliation, there is a real risk that the user may perceive such audits as being of higher quality than those where the group is audited by unrelated firms, an assumption that would clearly be flawed and one which has the potential to unfairly impact competition in the audit market, to the detriment of SMPs.

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?*

Notwithstanding our response to Q11 concerning the overall length of the report, the SMP Committee has a range of diverging views on whether standardized material should be allowed to be relocated to a website or an appendix.

For example, some committee members believe that, while relocating this material would help reduce the length of the report, it is doubtful whether many readers would bother to refer to the website or appendix, thus risking increasing the expectation gap. Also, on a conceptual level, some



believe that relocation may be perceived as relegating the importance of such content, thus perhaps running counter to the IAASB's objective of enhancing the report.

Conversely, some welcome the fact that reducing the profile of standardized material would enable the user to focus more clearly on valuable entity-specific content.

One solution suggested would be to allow the use of a link or an appendix for standardized material in a clean report, but to require the full text to be included in the report in instances where a modified opinion is issued. This may help to provide sufficient context for the overall audit opinion, as appropriate under the circumstances. However others suggested that a modified report already carries a requirement to disclose the basis for the modification, therefore such a distinction is not relevant to how this information should be presented.

In conclusion, we feel the diversity of opinion amongst the committee is indicative of the cultural diversity of our constituency. As such, we feel unable to advocate one particular global approach from an SMP perspective. We therefore suggest that the decision on whether to allow the standardized material to be relocated to a website or an appendix is best left to national standard setters.

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 have no objections to the IAASB's suggested structure of the illustrative report.

- 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?***

Global consistency should be encouraged wherever possible as the audit report is the public face of the audit. The more constant the form of the message, the more likely it will be valued by users, both globally and locally.

We therefore believe that the building blocks approach proposed in the ITC is suitable and will allow for consistency of the report across jurisdictions while also enabling national differences and/or entity-specific differences to be suitably accommodated.

- 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 agree that 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. We believe this approach will achieve a suitable degree of global consistency while also enabling national reporting requirements and practices to be suitably accommodated. We would oppose any flexibility beyond this, however, as this would unnecessarily reduce the comparability of auditors' reports internationally.



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?

Our responses throughout this letter are informed by what we perceive as the needs and interests of the SMP/SME environment.

One further comment we would make is based on the fact that increasing numbers of SMEs around the world are becoming exempt from statutory audit requirements. When an audit is voluntarily commissioned, rather than a statutory requirement, it may be performed by non-professional accountants. As such, we believe it is in the public interest that users are provided with information on the qualification, standing and capabilities of the auditor, since the users can no longer rely on statutory or regulatory approval when the audit is voluntary.

In particular, we believe it is important for the auditor to be allowed to refer, either through the report directly or indirectly through web-based information, to those matters that present users with appropriate information to take a view on the quality of the auditor. Disclosing the auditor's obligations to maintain a suitable system of quality control (under ISQC 1 or requirements that are at least as demanding), including in particular meeting competency requirements and prescribed ethical requirements, and indicating any independent oversight regime in place over the auditor, would allow stakeholders to draw an appropriate degree of comfort from the report. These factors are integral to the underlying value of an audit, and raising public awareness of them also helps distinguish a professional accountant from an unqualified accountant, an issue that is particularly sensitive in the SMP environment.

Concluding Comments

We hope the IAASB finds this letter helpful in further developing proposals to enhance the quality, relevance and value of auditor reporting. In turn, we are committed to helping the IAASB in whatever way we can to build upon the results of this ITC. We look forward to strengthening the dialogue between us.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

A handwritten signature in black ink, appearing to read 'Giancarlo Attolini', written over a horizontal line.

Giancarlo Attolini
Chair, SMP Committee