



30 September 2011

Our ref: ICAEW Rep 91/11

Mr Martin F. Baumann, Chief Auditor, PCAOB
1666 K Street, NW
Washington, D.C 20006
USA

Dear Mr Baumann

Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

ICAEW is pleased to respond to your request for comments on the PCAOB *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Katharine E Bagshaw FCA
ICAEW Audit and Assurance Faculty
T + 44 (0)20 7920 8708
E: kbagshaw@icaew.com



ICAEW REPRESENTATION

CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS AND RELATED AMENDMENTS TO PCAOB STANDARDS

Memorandum of comment submitted in September 2011 by ICAEW, in response to the PCAOB *Concept Release on Possible Revisions to PCAOB Standard Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* published in June 2011

Contents	Page
Introduction	2
Who we are	2
Major points	2
Responses to specific questions	6

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* published by the PCAOB on 21 June 2011, a copy of which is available from this [link](#). We have prepared this response alongside our response to IAASB on its current consultation on auditor reporting *Enhancing the Value of Audit Reporting: Exploring Options for Change*.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Audit and Assurance Faculty is a leading authority on external audit and other assurance activities and is recognised internationally as a source of expertise on audit issues. It is responsible for technical audit and assurance submissions on behalf of ICAEW as a whole. The faculty membership consists of nearly 8,000 members drawn from practising firms and organisations of all sizes from both the private and public sectors. Members receive a range of services including the monthly Audit & Beyond newsletter.

MAJOR POINTS

5. Key Messages
 - The current auditor reporting model works well but there is room for improvement within the broader spectrum of auditor and corporate reporting. The demands for change from investors in larger listed companies need to be justified and there is no need for smaller companies to be subject to all of the reporting requirements of larger companies. Investors and other users are best served by better quality reporting by companies and more relevant reporting by auditors; more reporting for its own sake will not help anyone.
 - Differing corporate governance regimes from which auditor reporting practices arise are likely to remain legally, culturally and economically highly jurisdiction-specific. Efforts should therefore be made by standard-setters towards the convergence of reporting requirements wherever possible, on the basis of high-level high-quality principles.
 - The following principles should underpin any standard-setting activity in this area:
 - companies should provide high-quality information on which auditors report; auditors should only provide original information about companies in exceptional circumstances
 - the pass/fail model should be retained
 - auditor reporting should be in sufficient detail to provide transparency about what auditors do and their findings, but not so detailed as to obscure key messages.
 - The overall strategy for the evolution of auditor reporting should match short-term improvements to the format and content of the auditors' report with more ambitious longer term solutions in the form of improvements to the provision of wider-ranging auditor assurance.

The Current Auditor Reporting Model and UK Reporting Initiatives

6. It is clear from research that the current auditor's report has value in the eyes of investors. It is also evident that auditor reporting has in fact changed substantially in recent years. What has not changed is the extent to which the current framework is a pass/fail model and the overarching opinion provided by auditors continues to be valuable to investors the world over. The significance of a 'clean' audit report to companies seeking listings on the world's stock exchanges is easily overlooked. More can certainly be done though and much of the rest of the debate is about who provides additional information, where, what sort of assurance, if any, can be provided on it, and indirectly about the need for improvements to corporate reporting, and how the quality of auditor reporting can be assessed.
7. The Audit Quality Forum (AQF), convened by ICAEW, considered the issue of auditor reporting in 2006, and its work was instrumental in stimulating the debate internationally. It considered the information that shareholders wished to see in the audit report, why they wanted it, barriers to change and ways to overcome them. The report noted that some shareholders want more discursive information within the audit report, covering uncertainties and risks and details of difficult, sensitive or contentious issues, for example, which would typically be discussed in the UK with the audit committee¹.
8. The AQF debated a number of other auditor reporting issues in subsequent years including reporting on the Internet and auditor signatures on audit reports, which widely influenced thinking of these matters. More recently, ICAEW responded to the FRC in the UK on its *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* consultation dealing with the content of and reporting on audit committee reports. We also responded to IOSCO on its auditor communications consultation. In both cases, we argued that one effective way forward in this area is in audit committee reporting, and auditor assurance on those parts not dealing with information provided by the auditor.
9. Most recently, ICAEW's Financial Reporting Faculty is about to publish a thought leadership work entitled *Reporting Business Risks: Meeting Expectations* as part of its *Information for Better Markets* series which deals with the current position in the USA, Canada, Italy and Germany as well as the UK, and with calls for enhanced reporting and the challenges and opportunities in meeting those demands.
10. Changes to auditor reporting are desirable and may involve reporting on areas of significant audit risks, but we believe that there is a strong case for addressing deficiencies in financial reporting, by better application of the requirements that already exist and by means of additional reporting requirements, if necessary. In the UK, the USA, and elsewhere, frameworks for risk reporting are in place but a minority of companies continue to provide a minimum and comply with the letter of the law only. We believe that regulators might seek to change behaviour *vis a vis* the existing framework before proposing new requirements, but investors will be disappointed if they expect auditors to remedy the provision of scant or poor quality information about business risks by requiring them to report on significant areas of audit risk. Business risks and significant audit risks are not the same. Auditors cannot disclose what they are not privy to and management will not furnish auditors with information that they are not prepared to disclose themselves. We encourage regulators to apply greater pressure to companies to provide better quality disclosures, even when they satisfy the minimum requirements. If the minimum requirements are in fact inadequate, they should be improved. In February 2011, the UK's Financial Reporting Review Panel highlighted the need for better reporting by companies of the principal risks and uncertainties they face.²

¹The report of the working group can be found at www.icaew.com/en/technical/audit-and-assurance/audit-quality-forum-aqf/fundamentals

² www.frc.org.uk/frfp/press/pub2503.html

11. The FRC's September 2011 papers *Boards and Risk – A Summary of Consultations with Companies, Investors and Advisors* and *Effective Company Stewardship - Next Steps*³ propose that company narrative reports focus primarily on strategic and major operational risks rather than indiscriminate lists of risks that all companies face. It is proposed that the audit committee's remit should be extended to include consideration of the whole annual report and to ensure that the report, viewed as a whole, is fair and balanced. There are also proposals regarding auditor reporting on inconsistencies between the annual report and the financial statements and for a financial reporting laboratory in which preparers, auditors and other stakeholders experiment with novel forms of reporting.
12. While ICAEW is an international body, in this response we give a number of examples of changes that have been proposed or implemented in the UK. All of these examples are predicated on the UK corporate governance framework which is not in place elsewhere. We recognise this limitation. Nevertheless, we offer these examples in order to demonstrate the manner in which high-level principles might be applied at a local level.

The Significance of Corporate Governance Regimes and the Desirability of Convergence

13. Auditor reporting is an area in which there is a pressing need for high-level principles which can be topped and tailed to meet local needs. We consider ourselves champions of international auditing standards in the UK and we engaged at a very early stage with investors through the AQF. Despite all of this, we struggled to adopt international standards on auditor reporting which reflects, among other things, the difficulties associated with prescription in this area. The diversity of practice in auditor reporting is more entrenched than diversity in audit practice generally not simply because auditor reporting is often legislated, but because of the incentives and disincentives to convergence arising from different corporate governance models and the different strengths, capabilities and focus of audit committees and auditors in different jurisdictions. Answers to auditor reporting questions depend on local governance frameworks and no auditing standard-setter or regulator is in a position to engineer change in this area without engaging all of the relevant stakeholders, and there are many. Attempts to do so by means of prescription in auditing standards are unlikely to be successful and may lead to unintended consequences, in the form of non-compliance with auditing standards and more defensive auditor behaviour which risk bringing standard-setters into disrepute. We encourage the PCAOB and IAASB to be diligent in their attention to each other's work in this area and urge them to co-operate as much as they can on their respective consultations. It would be a pity and a wasted opportunity if the two consultations resulted in further divergence which is a real risk, particularly if either or both bodies propose changes that are too prescriptive. We cannot avoid the impression that the number of questions in both consultations implies a premature attention to detail, rather than a broader consideration of the higher-level and more important issues, and we emphasise the suggested principles needed to underpin standard-setting noted in our key messages above.

Principles Underpinning Standard-Setting

14. Both the PCAOB and IAASB consultations propose two options: the first is enhancements to the current reporting regime without change to the fundamental premise of an audit in which independent auditors report on information prepared by companies; the second involves change to that fundamental premise whereby auditors produce original information about the company that is not already provided by management. We believe that auditors should only provide original information about companies in the exceptional circumstances in which it is required by law or regulation. The independent audit is predicated on this assumption and confusion will arise if the responsibility for reporting is split between auditors and management. Most audits are attest engagements which require independent auditors to report on

³ <http://www.frc.org.uk/press/pub2632.html>

information provided by management. Their strength derives from a combination of auditor independence and the pass/fail model. Other models may be more fluid, may not require auditor independence and may permit original reporting by auditors. All have a place, but they should not be mixed together to avoid calling into question the all-important pass/fail assessment. Furthermore, we believe that it is likely that both options may lead, rightly or wrongly and whether intended or not, to changes in the conduct of audits and auditor behaviour, and that those changes may not necessarily be positive. The more detailed the proposals, the more likely it is that behaviour will change. The IAASB and the PCAOB need to be aware of the possibility of more defensive auditing whereby auditors perform procedures in order to mitigate the risk of claims rather than to improve the quality of the audit, of a greater level of involvement of lawyers in the reporting process, and of less frank exchanges with management and audit committees if more of what is discussed is likely to be reported.

15. There are calls for the demystification of the audit process and for information about both the audit and the audited entity to be provided. Some additional information may usefully be provided by auditors about the audit and by management about the audited entity. We believe that there is merit in careful consideration of the possibility of auditor reporting on significant audit risks, either within the audit report or elsewhere, however, we believe that there is a lot of work to be done if boilerplate is to be avoided. Business risks as reported by the entity are not the same as significant audit risks, although in many cases they cover similar ground, and it is important that all stakeholders are clear as to the difference to avoid confusion as to whose 'version of reality' is to be believed. Current auditing standards do not equip auditors to report on business risks and while they can be developed, for auditors to report on business risks that are not also audit risks would compromise their independence and result in them substituting their judgement for, or subordinating their judgement to, that of management, instead of attesting to management's assertions.
16. Investors involved in this debate are already well aware that audit quality, on which they seek more information, comprises many elements and is not something that can be demonstrated quickly or easily. They are also aware that the provision of some of the information called for may be interesting, but that it will not enable informed decisions to be made about audit quality. Furthermore, investors are well aware that any information provided to the audit committee takes place in the context of an extended dialogue with the audit committee. To ask auditors to provide that information out of context is likely to cause confusion.

Changes to the Format and Content of Auditor Reports and Longer- Lasting Improvements

17. While changes to the form and content of standard elements of the audit report may be relatively easy to achieve, and therefore attractive, we think it unlikely, on the basis of past experience, that they will significantly improve communications overall. Of themselves they are unlikely to have any significant effect on the information or expectation gaps. Equally, while we can support changing the placement and content of responsibility statements which might fulfil a desire among auditors to articulate their position more clearly, such changes are unlikely to make a significant impact on what users believe auditors are or should be doing, and any change risks an increase in the expectations gap.
18. While the need to cut clutter in financial reporting is not currently so much of an issue in the US as it is elsewhere, there are difficulties in reconciling calls for enhanced reporting made at the same time as calls to cut clutter. In some jurisdictions, continuing to add to the financial statements and auditor reporting has already resulted in overload and a complex navigation exercise to determine what is relevant, and what has been audited, reviewed or read and what has not. It is clear, at least in Europe, that investors want more relevant, better information which is sometimes already provided but can be difficult to find. Additional disclosures should not be provided merely to satisfy curiosity and investors in listed companies should explain how the information called for will be used in the decision making process. We support, as noted above, the concept promulgated by the FRC of a financial reporting laboratory in which

preparers, auditors and other stakeholders consider novel forms of reporting, how to avoid the natural tendency to revert to boilerplate, and how users of financial information can better navigate the information that is already made available to them.

19. We believe that both the PCAOB and the IAASB need to take a step back and consider the issue of auditor communications in a holistic manner. We are pleased that the IAASB has recognised the importance of corporate governance in this context but we believe that concrete proposals are premature. Both consultations focus heavily on the detail of auditor reporting and both are light on the need to balance the broad issues of investor needs, which are not homogenous, their desires, which are not necessarily the same as their needs, and what auditors and management are able to legitimately and usefully provide. Both consultations are also light on the inhibitory effects of the liability regime on auditor willingness to report.
20. Financial reporting has changed in recent years. There is a perception that auditor reporting has not kept up and there is certainly an appetite for change both in Europe and the US. We believe that it is essential that changes are real, that the costs are recognised, and that benefits can be measured. A great deal of heat and light may be generated in this debate but it is essential that change does in fact lead to greater investor satisfaction and convergence internationally, and that regulators and the profession do not simply make change in order to be seen to be doing so. We do not believe that, as has been suggested, that the benefits of the proposals can be realised at no cost, or are cost-neutral and we urge the PCAOB and the IAASB not to disregard this issue.

PCAOB Proposals

21. We believe that there is merit in exploring the provision of assurance on additional information outside the scope of the financial statement audit provided that the information assured forms part of an acceptable financial reporting framework or meets criteria similar to those found in *ISAE 3000 Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*.
22. In order of preference, we believe that the following proposals are likely to be most productive in improving investor understanding of the audit:
 - clarifications to the audit report
 - encouraging the proper use of emphases of matter
 - assurance on information outside the financial statements, including assurance on audit committee reporting
 - commentary on significant audit risks, however, we do not believe that an auditor's discussion and analysis (AD&A) is feasible.

While on the face of it an AD&A seems to nicely parallel the MD&A, the parallel is shallow. The proposals mix information about the audited entity and the audit and invite a comparison, between the auditors' account and that of management. Whilst this may be entertaining, briefly, it will not be helpful because it will cause confusion, encourage auditors and management to be excessively cautious, and force them even closer together when the annual report and AD&A are being prepared at the very time at which auditors should be and be seen to be independent. Investors will be unhappy if auditors and management report different things, and even unhappier if they report the same things.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

a. Should the Board undertake a standard-setting initiative to consider improvements

to the auditor's reporting model? Why or why not?

23. The Board should undertake an initiative to consider improvements to the auditor's reporting model. Standard-setting is only part of it. Financial reporting has changed in recent years and while auditor reporting has also done so, perhaps more than is generally acknowledged, there is a perception that further change is desirable. It is important that careful consideration is given to who provides additional information about the entity and the audit, where that information is provided, and to the need for the net result of change to be improved communication rather than more confusion which is a risk, particularly if the changes proposed are too prescriptive and do not converge with changes proposed by the IAASB.

b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

24. We believe that clarifications to the audit report, encouraging the proper use of emphases of matter in limited circumstances, commentary on significant audit risks either within the auditors' report or outside it, and separate assurance on other information outside the financial statements may help, to varying degrees, with improving investor understanding of what auditors have done.

c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

25. Yes, the Board should consider expanding the auditor's role to provide assurance on matters in addition to the financial statements. There are many new areas in which non-audit assurance is being developed, including reporting on review engagements and CSR statements. In the context of this concept release we believe there is merit in considering the provision of assurance on audit committee reporting. This stands more of a chance of maintaining the proper relationship between auditors and management and of providing investors with more of the information they need, than some of the other proposals. AT 701 sets forth attestation standards and provides guidance to auditors concerning the performance of an attest engagement with respect to management discussion and analysis. Although issued more than 10 years ago we understand that there are very few examples of such reports being issued. This may be due to limited investor demand for such reports and the unwillingness of management to incur the additional costs associated with such engagements.

26. The FRC's January 2011 Consultation Paper *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* recommends, among other things, that directors should describe in more detail the steps they take to ensure transparency about the activities of the business and any associated risks. Its September 2011 papers *Boards and Risk – A Summary of Consultations with Companies, Investors and Advisors* and *Effective Company Stewardship - Next Steps* note that the FRC proposes to ensure that company narrative reports focus primarily on strategic and major operational risks, rather than indiscriminate lists of risks that all companies face. It is possible that separate auditor assurance on these risks outside the main auditors' report will be considered.

27. While the US and UK models of corporate governance are not the same and the roles of audit committees are different, we believe that the high-level issues noted above are of an appropriate level to be considered by the Board in developing principles for auditor reporting.

Q2: The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a 'pass/fail model.'

Should the auditor's report retain the pass/fail model? If so, why?

If not, why not, and what changes are needed?

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

- 28.** The pass fail/model is one that investors are broadly happy with and the current model is not broken. It was developed because of inconsistency in auditor reporting and its success and significance should not be underestimated or obscured. Companies can neither obtain nor maintain listings on the world's stock exchanges if they 'fail' the audit test and a huge amount of effort goes into obtaining a 'pass'. Companies in transition economies often do not pass and the sometimes manifold reasons for their failure are listed in auditors' report. Audit reports give no indication as to the quality of the audit performed though, and there are calls for the demystification of the audit process and for the provision of more information about the audit and the audited entity. We believe that some additional information may usefully be provided by auditors about the audit and by management about the audited entity as indicated elsewhere in this response. Nevertheless, we believe that investors involved in this debate are already well aware that audit quality, like quality in other professions, comprises many elements and is not something that can be demonstrated quickly or easily. They are also aware that the provision of some of the information called for may be interesting, but that it will not enable informed decisions to be made whether a high quality audit has been performed.
- 29.** Information provided by auditors to the audit committee is in the context of an extended dialogue, in which the information provided is sometimes only the starting point. To ask auditors to provide that information out of context is likely to cause confusion. It is important that if investors are provided with the information they ask for on significant audit risks, they accept that there is likely to be overlap with information provided by management on key financial reporting risks, that there will be different slants, and that they should not expect that auditors and management 'agree' on common wording.

Q3: Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

- 30.** It is clear from our discussions with some investors that while they understand the need for information about the entity to come from management, they do not always trust management to give a balanced view and would rather have the same information from the auditor. This lack of trust and the desire of some investors to exert better control over management underlie many of the calls for more information, rather than assurance, to be provided by auditors, but it calls into question the fundamentals of the relationships between management, auditors and investors.
- 31.** Auditors are appointed to report on information provided by management, to, or for the benefit of, investors or the capital markets. In order for the audit to be credible, the auditor needs to be independent not only of management but of the audited information. Auditors should only provide original information about companies in the exceptional circumstances when it is required by law or regulation. Confusion is likely to arise if the responsibility for reporting is split between auditors and management. The auditor cannot provide information about the audited entity independently of management – the auditor relies on management for that – and if the auditor then puts his own slant on the information provided by management the auditor is no longer independent of the information he is reporting on. Furthermore, and perhaps even more importantly, if management is aware that auditors will take the information provided and alter it in some way they will be reluctant to provide it.
- 32.** While additional information about the company's financial statements should come from management, and cannot come from auditors, it may also come from audit committees. We

believe that investors should be turning their attention to the quality of people on audit committees and their processes and reporting functions. Much valuable information about the audited entity can be provided by audit committees which are in a better and more proper position than external auditors to provide and report on detailed information and explanations about the audited entity. External auditors are then in a position to provide assurance on this information.

Q4: Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?

33. We do not comment on this question.

Q5: Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

a. If you support an AD&A as an alternative, provide an explanation as to why.

b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

d. If you do not support an AD&A as an alternative, explain why.

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?

34. At first sight, the notion of an AD&A is an attractive one. It appears to parallel the MD&A and might offer scope for creativity in auditor reporting and provide something new for investors to read. We believe that the costs of an AD&A would be substantial, so much so as to significantly outweigh the benefits, not least because of the need to involve lawyers because of the liability regime. This in turn would lead to it reverting to boilerplate or near boilerplate over a very short space of time. The overlap with the MD&A would cause confusion and, certainly in Europe, it would very likely be perceived as adding to the clutter. We do not believe that an AD&A is feasible.

35. There may be some scope for limited auditor reporting on areas that constitute significant audit risks, particularly on critical accounting policies and on auditor independence. This information could be provided either within the auditor's report, although auditor's reports are already very long in some cases, or outside it, either as a supplement or in a separate document.

Q6: What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

36. We note in our answer to question 5 above that we do not believe that an AD&A is feasible. We do believe however, that there is some scope for limited auditor reporting on significant audit risks, particularly on critical accounting policies and auditor independence. It would not be helpful for auditors to provide a wide spread of detail on all risks, nor a great depth of detail on the significant risks, because this would almost certainly serve to divert attention from what investors are really interested in, which are the broad areas to which auditors devoted their attention in which the big audit judgements were made. Less is increasingly more. Even less useful would be reporting on the extensive mechanics of audit procedures applied and the audit methodologies used as these, of themselves, are of little use in explaining how judgements are applied, which remains at the heart of auditing. Any such reporting would

amount in any case to extensive boilerplate and it is helpful to remember in this context that it also for audit regulators consider auditor methodologies.

Q7: What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (ie, management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including 'close calls')?

37. Reporting the auditor's 'views' on the company's financial statements, if they could be articulated, would be highly subjective and vague at best. Reporting on management's judgements and estimates is likely to be covered by reporting on significant audit risks as noted in our answer to question 5 above, as are difficult and contentious issues which, if material, are almost by definition 'significant audit risks'.
38. It is clear that some investors trust neither management nor auditors and would like to be able to challenge auditors' judgements by effectively re-conducting the audit themselves, by micro-managing the auditor's work, or by reading the auditor's files. No amount of additional information is likely to satisfy such investors and the call for reporting on 'close calls' demonstrates the lack of understanding of how broad the range of acceptable management estimates can be in some cases. It also demonstrates the naïve belief that the pass/fail model that can be measure much like an exam script, in that 49% is a fail, and 51% is a pass, and auditors are failing to distinguish clearly between 51% passes and the 75% passes. The audit opinion is just that, an opinion and companies are not entered into a competitive audit examination in which their financial statements can be marked and one company's financial statements deemed better than another's. Audit qualifications represent a fail, albeit excused in some cases, and multiple qualifications, adverse opinions and disclaimers represent bad fails. But 'awards' bestowed by auditors for better or fairer application of accounting standards, say, would put the auditor in the position of reporting on management's performance which does not help investors who do this themselves, and who make it clear from time to time that they do not require auditor help with this. Investors require auditor expertise to report on the fairness of reporting *vis a vis* the company itself, not management.

Q8: Should a standard format be required for an AD&A? Why or why not?

39. If an AD&A is required, guidelines as to the main headings and the matters to be included might be helpful to auditors.

Q9: Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

40. It is inappropriate for auditors to provide original information about the entity as to do so would fundamentally alter the relationship between management, auditors and investors. Information on business, strategic and operational risks should come from management and should in any case already be included under most reporting frameworks in annual reports.

Q10: How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

41. Avoiding boilerplate and achieving consistency are antagonistic aims. To begin with, any new type of reporting that is not heavily prescribed will lack consistency, particularly across organisations. Over time, consistency will be achieved but boilerplate will have crept in. This is not of itself necessarily an evil, rather it is just one dynamic of reporting. The simple process of introducing new reporting requirements results in more reading of reports which helps user understanding, even if over time this drops off.

Q11: What are the potential benefits and shortcomings of implementing an AD&A?

42. Implementing an AD&A would provide something new for investors to read but the costs are likely to be substantial and its value limited for the reasons set out elsewhere in this response.

Q12: What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

43. Investors are likely to make comparisons between an AD&A and the MD&A and it is inevitable that however diligent management and auditors are in trying to avoid inconsistency or competition, they will arise. This will further erode confidence in both management and auditors as investors would naturally seek to align, probably without much success, management and auditor views. If management and auditors provide the same view investors will have cause to question auditor independence and ask why they are paying for two identical reports.

B. Required and Expanded Use of Emphasis Paragraphs

Q13: Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

44. It is important to ensure that the desire among investors for more information about emphases of matter does not result in the currency of emphases of matter being debased through over or inconsistent usage. The illustrative emphases of matter cover matters such as related parties, 'unusually important' subsequent events and certain accounting matters and are certainly of current interest, but it is likely over time that they will be routinely added to, creating substantial clutter in audit reports. The purpose of emphases of matter is not to remedy defective accounting but to draw users' attention to matters that are critical to the understanding of financial statements. One of the reasons that investors are unhappy with the status quo is because of how companies report. The remedy may be clarification of and better application of existing requirements and the enforcement thereof, not asking the auditors instead. Subsequent events and related parties will not always be critical, even though they are often important. It is also important to remember that emphases can easily be used in the place of or misconstrued as qualifications. This may be less of a problem for companies and investors than it is for auditors. Auditors may be tempted to abuse emphases of matter in circumstances in which a qualification may be more appropriate, enabling them to avoid the need to put pressure on management to change an accounting treatment or disclose a matter in order to avoid the qualification.

Q14: Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

45. The Board might consider a requirement to consider including areas of emphasis but to require auditors to do so will inevitably result in the re-iteration year after year of 'key areas'. This would be counter-productive to the extent that in some years, a key area would be critical and in other it would not, but users of financial statements are likely to miss the significance of any changes in wording as a result of habitual (over) exposure to a note about the same issue. Key audit procedures will only add to clutter and will not be helpful to investors for the reasons outlined in our answer to question 6 above.

Q15: What specific information should required expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

46. We believe that if the PCAOB wishes to increase the level of usage of emphases of matter and the level of detail provided therein, it would be better to police their existing use more effectively through regulatory measures than to changes the rules, which are adequate.

Q16: What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

47. A short and carefully crafted but clear description of the issue in appropriate circumstances that takes up a few lines is likely to be more helpful to investors than half a page of boilerplate written by lawyers.

Q17: How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?

48. If emphases are mandated, boilerplate is inevitable. If more rather than less is encouraged, boilerplate can be put off for longer.

Q18: What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

49. The potential benefits of implementing required and expanded emphasis paragraphs are very limited and the potential shortcomings are extensive. They include auditors misusing emphases where qualifications are more appropriate, boilerplate and the loss of distinction between routine key issues and non-routine critical issues. Better application and enforcement of the existing regime and clear regulatory steer might help encourage the appropriate use of emphases.

Q19: Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

50. Yes, the Board should consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model. Assurance outside the financial statements will avoid the build-up of clutter in over-laden audit reports where it does not yet exist might ameliorate it where it does.

b. On what information should the auditor provide assurance (eg, MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

51. Auditors are best able to report on and develop tools and techniques for reporting on information provided in the context of an acceptable financial reporting framework or information that meets criteria similar to those set out in ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*. To the extent that the MD&A contains a fair amount of forward looking information that is only very loosely related to the financial statements, and may or may not meet criteria similar to those in ISAE 3000, providing assurance thereon is likely to prove difficult and, in practice, auditors are likely to report selectively thereon. Auditors may be able to provide assurance on earnings releases if they contain GAAP information and certain types of non-GAAP information outside the main financial statements if they meet the aforementioned criteria.

c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

- 52.** In order to answer this question, it is necessary to have a framework for reporting such as IAASB's ISAE 3000. The most appropriate level of assurance depends on the work effort and this in turn depends on what the market is prepared to bear in terms of cost.
- d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?
- e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?
- f. Are the requirements in the Board's attestation standard, AT sec.701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?
- g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.
- 53.** To add to the patchwork of reporting by reporting selectively on elements of the MD&A would be a regressive step and add to confusion in an already muddled area.
- 54.** We note above our understanding that AT 701 which sets forth attestation standards and provides guidance to auditors concerning the performance of an attest engagement with respect to management discussion and analysis is not widely used. More tailored standards are likely to be required

Q20: What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

- 55.** It is possible that where financial reports are cluttered, the potential benefit of implementing auditor assurance on other information outside the financial statements is in improving the current situation in which it is difficult to determine which parts of annual reports have been audited, reviewed or read.

Q21: The concept release presents suggestions on how to clarify the auditor's report in the following areas:

- Reasonable assurance
 - Auditor's responsibility for fraud
 - Auditor's responsibility for financial statement disclosures
 - Management's responsibility for the preparation of the financial statements
 - Auditor's responsibility for information outside the financial statements
 - Auditor independence⁴²/ AU sec. 550.04 - .06.
- a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?
- b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.
- c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?
- d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

Q22: What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

56. The principal benefit, although it not a significant one, of clarifying the auditor's report in the areas noted in question 21 above is that the report will better articulate the auditor's position. But clarification is unlikely to serve any useful educational purpose as it is clear from IAASB's research that the boilerplate in auditors' reports is not read, in much the same way as any 'small print' is not read (and the more there is of it, the less likely it is that it will be read). The main function of the audit report is as a medium through which to transmit the all-important pass/fail assessment. All of the matters noted above are already dealt with in audit reports and the fact that there is more to read will neither encourage reading, nor will it enhance comprehension. The fact that auditors protest, even more vociferously than they do now, that the purpose of the audit is not to detect fraud *per se*, will do nothing to change the belief that auditors should do so. The principal shortcoming is that clarification will give the appearance of improved communication without actually doing so.

Questions Related to all Alternatives

Q23: This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

Q24: Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?

57. In order of preference, we believe that the following proposals are likely to be most productive in improving investor understanding of the audit:

- clarifications to the audit report
- encouraging the proper use of emphases of matter by regulatory means, among others
- assurance on information outside the financial statements, including providing assurance on audit committee reporting and
- commentary on significant audit risks and auditor independence, but we do not believe that an AD&A is feasible or practical for reasons we set out elsewhere in this response.

Q25: What alternatives not mentioned in this concept release should the Board consider?

58. We believe that the PCAOB and IAASB need to take a step back and consider the issue of auditor communications in a holistic manner. Both consultations focus heavily on the detail of auditor reporting and both are light on the need to balance the broad issues of investor needs, their desires, and what auditors and management are able to legitimately and usefully provide. Both consultations are also light on the inhibitory effects of the liability regime on auditor willingness to report.

59. The auditor's report has value and is not broken in the eyes of investors. It has changed substantially in recent years. What has not changed is the pass/fail model and it is clear that investors value the overarching opinion provided by auditors. More can certainly be done though and much of the rest of the debate is about who provides additional information, where, what sort of assurance, if any, can be provided on it, and indirectly about the need for improvements to corporate reporting and how the quality of auditor reporting can be assessed.

Q26: Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

60. We strongly recommend that the Board consult with the IAASB on an auditor reporting framework. Both Boards and all of their stakeholders would benefit from such a dialogue because any framework needs to be able to accommodate different corporate governance regimes in order to be effective.

Q27: Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

61. There is always a risk that change results in misunderstanding but the risks of missing or underestimating the significance of auditor red flags are much more important than the risks of overestimating their importance.

Q28: Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

Q29: What effect would the various alternatives have on audit quality? What is the basis for your view?

62. Auditor reporting is an integral part of audit quality and misconceptions regarding audit quality arise in part from a failure by auditors to communicate adequately. It is important to note the possibility that the demystification of the audit might result in its marginalisation or in calls for auditors to take on a radically different role to the one they play at present.

Q30: Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.

63. We do not comment on this question.

Q31: This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which ones and why?

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?

64. The concept release is light on the impact of liability considerations which actively inhibit what auditors are able to say. We note elsewhere in this response, and particularly in our answers to questions 5, 11 and 18 that in some cases, the costs may significantly outweigh the benefits of the proposed changes. We hope that overall that the changes arising from these discussions will result in more efficient audit effort. We also believe that the PCAOB should actively consider the benefits of convergence with IAASB in this area.

Q32: The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

65. We note in our answers to questions 3, 7 and 9 that while some investors understand the need for information about the entity to come from management, they do not always trust management to give a balanced view and would rather have the same information from the auditor. It is inappropriate for auditors to provide original information about the entity as it would fundamentally alter the relationship between management, auditors and investors.
66. Auditors are appointed to report on information provided by management and in order for the audit to be credible, the auditor needs to be independent of management and the audited information. The auditor cannot provide information about the audited entity independently of management and if the auditor puts his own slant on the information provided by management the auditor is no longer independent of the information he is reporting on. If management is aware that auditors will take the information they provide to them and alter it in some way they will be reluctant to provide it.
67. While additional information about the company's financial statements should come from management, and cannot come from auditors, we believe that going forward it is more likely to come from audit committees. Investors should focus on the quality of people on audit committees, their processes and reporting functions. Much valuable information about the audited entity can be provided by audit committees and external auditors are then in a position to provide assurance on it.
68. We also make it clear that while some investors trust neither management nor auditors and would like to be able to challenge auditors' judgements by effectively re-conducting the audit themselves by interrogating auditors, no amount of additional information is likely to satisfy such investors.

Ekbagshaw@icaew.com

Copyright © ICAEW 2011
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

icaew.com