Australian Government
Auditing and Assurance Standards Board

Level 7, 600 Bourke Street
Melbourne VIC 3000 Australia
PO Box 204, Collins Street West
Melbourne VIC 8007

21 November 2013

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

Dear James,

AUASB Submission on the IAASB's Exposure Draft

Reporting on Audited Financial Statements

The Australian Auditing and Assurance Standards Board (AUASB) is pleased to provide its submission to the IAASB's Exposure Drafts on enhancements to Auditor Reporting.

The AUASB continues to commend the IAASB's plan to improve auditor reporting. Exploring options that may help reduce the "expectation gap", achieve reporting that better meets users' information needs and aims to enhance the relevance of the audit is clearly in the interests of users, preparers, auditors and others involved in financial reporting.

Overall, the AUASB supports the initiatives to enhance auditor reporting through the introduction of a new standard (proposed ISA 701) and the consequential amendments to other existing standards. However, the AUASB has reservations about some of the proposals. The AUASB's main concerns fall broadly into three categories:

- Lack of clarity as to users' needs, and consequently, whether the proposals will result in effectively meeting those needs to the desired level;
- The identification of significant issues in the practical application of the Key Audit Matters (KAM) proposals; and
- A preference for reporting going concern issues by exception only.

The AUASB acknowledges that some investors supported the IAASB's proposals, with clear encouragement for increases and improvements in the information that auditors can provide. However, the AUASB questions whether the enhancement proposals will achieve the objectives in paragraph 7 of the exposure draft: changes in auditor reporting may have *positive benefits to audit quality or users' perception of it* (which) *in turn may increase the confidence that users have in the audit and the financial statements, which is in the public interest*.

In formulating its views and drafting this submission, the AUASB has considered:

- The Exposure Draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing* (ISAs);
- Input from numerous stakeholders (groups and individuals). This has been achieved through direct discussions, written submissions received, hosting forums and roundtables, and field test reports received. Contributors represented a broad range of backgrounds including auditing firms; public sector auditors; regulators; professional accounting bodies; academics; preparers of financial statements; directors, audit committee members; investors; and institutional analysts; and

- The relatively strong economic and regulatory environment enjoyed in Australia.

The AUASB takes this opportunity to reiterate its belief that changes are necessary to improve disclosure requirements in the *financial reporting framework*, particularly in relation to the going concern concept. The AUASB continues to support the IAASB's ongoing dialogue with the International Accounting Standards Board (IASB) to encourage appropriate changes to the International Financial Reporting Standards (IFRSs). Again, the AUASB commends the IAASB for reaching out to the IASB, regulators and other relevant stakeholders to consider enhancements to the existing financial reporting framework.

The AUASB's responses to the specific questions asked in the Exposure Draft accompany this letter as **Attachment 1**. Additional comments are provided in **Attachment 2** and are included for the IAASB's consideration.

Should you have any queries regarding this submission, please do not hesitate to contact me at *rmifsud@auasb.gov.au* or Howard Pratt at *hpratt@auasb.gov.au*

Yours sincerely,

Richard Mifsud
Executive Director

Attachment 1 – AUASB Response to the specific questions listed in the IAASB Exposure Draft
Attachment 2 – Additional Comments for the IAASB's Consideration

Attachment 1

AUASB Responses to the Specific Questions listed in the IAASB Exposure Draft

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?*

AUASB Response:

(a) From the wide range of input received, as described in the covering letter, the AUASB concludes that limited benefits have been identified to support auditor reporting in accordance with the proposals. Although some investors expressed positive support for the proposals, there was a general view from stakeholders that users of the financial statements would gain limited value from the introduction of key audit matters (KAM) as presently proposed.

(b) The most important issues raised by the AUASB's stakeholders can be summarised as follows:

(i) Lack of insight as to exactly who the "users" are and clarity about their information needs in respect of the auditor's report.

(ii) Uncertainty as to whether the proposals will achieve the intended enhancement to the extent that users will improve their understanding and assessment of the value of audit.

(iii) The risk of users being confused with the changes. For example:

- Assumptions that KAM are directly correlated to the most important issues in the financial statements that users should focus on—thus providing a short-cut to key financial statement disclosures;
- Assumptions that KAM provides some form of assurance on the individual KAM, but if no conclusion is given, users are left guessing and therefore the usefulness of KAM is questionable;
- Assumptions that KAM equate to a "soft qualification" or at minimum, an "amber warning" about issues reported in KAM; and
- Uncertainty about the difference(s) between an Emphasis of Matter and a KAM.

(iv) Inconsistent reporting—excessive or limited information provided in KAM according to the auditor's perception of whether "more" or "less" equates to an increase in exposure to their legal liability.

(v) Risk of boilerplate KAM narratives.

(vi) Concerns about the auditor being the first originator of information about the entity, particularly where KAM does not relate to a specific disclosure in the financial statements.

(vii) Perceived practical application difficulties, such as "negotiation " on wording or "opinion shopping", that are likely to attract costs, in terms of time and money and that such cost is not exceeded by derived benefits.

(viii) Concerns about auditors reporting on particularly difficult, sensitive and confidential issues that the auditor might discuss with those charged with governance, but are not individually disclosed in the financial statements - such as, complex tax strategies/disputes, commercially sensitive matters and issues related to poor management.

(c) A number of different stakeholder groups consulted by the AUASB believed that the introduction of KAM will positively affect the quality of the financial reporting process by:

(i) Prompting directors and audit committee members i.e. those charged with governance (TCWG) to improve their understanding of, and focus on, the format, content and disclosures made in the annual financial statements, particularly the Note disclosures;

(ii) Encouraging management and TCWG to minimise “additional” auditor reporting through better financial statement disclosures;

(iii) Motivating TCWG to improve the nature, extent and timing of their questioning of management regarding the financial statements; and

(iv) Where necessary, providing leverage for the auditor to encourage changes in the behaviour of “recalcitrant” preparers to appropriately include the required financial statement disclosures.

(d) A number of stakeholders expressed preference for the *format* of the auditor’s report on Vodafone plc. (31 March 2013). Particular support was directed to the use of colour, succinct bullet points, columns and shorter sentences which in concert were perceived to provide an altogether easier document to read and understand.

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?*

AUASB Response:

(a) The AUASB believes that proposed ISA 701 in its current form needs further amendments for it to be an appropriate framework to guide the auditors in forming reasonably consistent judgments about determining key audit matters. The AUASB's particular concerns are focussed on paragraphs 8, A35 and A36 of proposed ISA 701.

Paragraph 8

(b) When determining areas of significant auditor attention, paragraph 8 prescribes 3 criteria for inclusion in the auditor's consideration. The AUASB does not support the criteria contained in paragraphs 8(b) and 8(c) for the following reasons:

(i) The requirements and guidance included in paragraphs 8(b) and 8(c) are effectively descriptions of circumstances that result in increased risk of material misstatement—which is the essence of the criterion referred to in paragraph 8(a).

"Significant risk" is a term defined in ISA 315, *the* fundamental pillar of the audit approach and is a well-understood concept that pervades the entire audit. Introducing criteria, such as those described in paragraphs 8(b) and 8(c) are an unnecessary complication that is not seen as improving the value of KAM.

(ii) A significant number of stakeholders expressed concerns on *how* to select KAM from the list of significant risks documented as part of the (ISA 315) risk assessment, and once selected, *how* best to document the rationale for the selections made.

(iii) "Significant difficulties", at paragraph 8(b), are commonplace, a very subjective concept and most often, "people-related". Accordingly, this criterion does not provide an adequate framework for *reasonably consistent* application.

(iv) The related paragraph 8(b) guidance material at paragraph A20 is limited to examples of difficulties in obtaining sufficient appropriate audit evidence. Describing "significant difficulties" (in obtaining audit evidence) in the KAM does not result in a valuable message for users. Instead, such description introduces a new concept—a problem that was resolved and therefore does not affect the opinion.

Such disclosure may result in users misinterpreting the information as the auditor pointing to a problem that has been only "marginally" overcome and is assumed to be unique to the entity. Furthermore, some AUASB stakeholders have argued that disclosing "difficulties" is in fact a "first disclosure of information" that is outside the responsibilities of the auditor and will result in difficulties with TCWG. Any KAM of this nature may be interpreted as a "user beware" warning, or a "soft qualification" that may inappropriately influence users' investment, and other, decisions.

Going Concern

The AUASB is particularly concerned at the lack of guidance when an auditor spends significant time and effort in relation to a *potential* material uncertainty regarding going concern, however, eventually concludes that no material uncertainty exists and accordingly no disclosures are made by the entity. Acknowledging that proposed ISA 701 paragraph 11 relates only to where a material uncertainty *does* exist, the scenario described above is not catered for.

Under the proposals, auditors may be placed in a difficult position. The circumstances described above would theoretically and logically fall within the definition of a KAM and as much time and effort has been spent, the auditor should include this important area in the KAM. However, such description will unquestionably be the first-time introduction of information, not otherwise available to users.

The undesirable consequences of this situation may likely be:

- Significant difficulties with TCWG and a consequential negative impact on the auditor's ongoing relationship with the entity.
- Potential problems where the (listed) entity is subject to continuous disclosure regimes, as is the case in Australia.
- Auditors defaulting to non-disclosure under KAM.

(v) Proposed ISA 701 paragraph 8(c) refers to "Circumstances that require significant modification of the auditor's planned approach…" The issue of significant deficiencies in internal control is used in the proposals as an example. The proposed standard does not consider the differing circumstances that may affect the intent, and therefore (*reasonably consistent*) application, of the requirement and guidance. For example:

- Poor planning by the auditor; or
- Good planning by an auditor with a long-standing knowledge of the entity versus "best effort" planning by a newly-appointed auditor.

AUASB Suggestions:

(i) In answer to the IAASB's questions relating to "appropriate framework" and "reasonably consistent auditor judgements", the AUASB suggests consideration be given to eliminating the criteria at paragraph 8(b) and 8(c) and retaining the requirements in paragraph 8(a) as the sole criteria.

(ii) In this way, auditor judgements regarding KAM will be consistently focussed on selections from identified significant risks and areas involving significant auditor judgements, and accordingly, will be harmonised with the overall risk-based audit approach and the primary objective of an audit. In addition, "significant risks" are already defined in ISA 315 assisting auditors to implement the new KAM requirements. This simple change will, in the AUASB's opinion, greatly improve consistency of understanding and application.

(iii) The IAASB may wish to consider using the material contained in paragraphs 8(b) and 8(c) as guidance (only) of circumstances that could lead to identified significant risks as described in paragraph 8(a).

(iv) The AUASB suggests specific guidance on the term "significance", as used in the KAM proposals, should be further developed and included in ISA 701. The ideal position would be to make reference to the definition of "significant risk" in ISA 315.

Paragraph A35

(c) The discussion at paragraph A35 is limited to "investigations, auditor confidentiality or data protection requirements". However, matters of commercial sensitivity, professional privilege and privacy occur commonly and create complex difficulties for the auditor, regardless of current proposals. Examples include complex tax strategies or disputes, litigation or commercial disputes, problems with management and regulatory investigations.

The AUASB considers that this area of conflicting obligations is likely to be the most common cause of practical implementation difficulties for auditors in determining and documenting KAM. The proposed standard does not provide sufficient guidance for auditors to systematically and logically deal with these everyday circumstances in the context of KAM.

<u>AUASB Suggestions</u>:

The AUASB suggests increased guidance be developed and included in ISA 701 with particular emphasis on:

(i) Defining clearly the circumstances when an auditor needs to recognise these areas of conflicting obligations and therefore, the need to follow a more considered approach than would perhaps otherwise be the case;

(ii) Providing a logical sequence of steps to work through in dealing with (such) a matter in the context of KAM, and particularly, the nature and scope of the KAM disclosures, especially when the entity is strongly opposed to the inclusion of the matter as a KAM;

(iii) Consultations, including legal advice and discussions with the audit engagement quality control reviewer; and

(iv) How to appropriately address, and resolve, disagreements with TCWG.

Paragraph A36

(d) To align with the suggestions directly above, consideration should be given to subsuming paragraph A36 into paragraph A35.

Overall

(e) From the results of some Australian field testing provided to the AUASB, it is clear that the exercise of professional judgement and the principles based approach can result in quite different considerations and decisions about KAM by different auditors. Accordingly, there is likelihood that the KAM of similar entities in the same industry and with similar risk profiles may be very different.

The AUASB still supports this inherent flexibility and does not support more prescriptive requirements to achieve greater consistency in application of proposed ISA 701, which could ultimately lead to boilerplate KAM, which is not a desirable outcome.

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?*

AUASB Response:

The AUASB believes the proposed requirements and guidance provide sufficient direction on the descriptions of individual KAM, however, the AUASB advocates further strengthening of the standard as follows:

As KAM will fall under the criteria described in paragraph 8, the AUASB is of the view that a direct reference to paragraph 8, together with a brief description of the criteria, will contribute to (global) *consistency* in providing clarity about the reasons for a matter being included in KAM.

The AUASB acknowledges the proposed guidance in paragraph A33, however, considers the following suggested changes to the requirement at paragraph 10, to be a valuable enhancement for both auditors and users of KAM.

<u>AUASB Suggestions</u>:

(i) Paragraph 10(a). In order to assist auditors with formulating their communications, consideration should be given to a direct link to the requirements in paragraph 8.

For example:

"An explanation of why the auditor, <u>under paragraph 8</u>, considered the matter to be one of most significance…"

(ii) Consideration should also be given to including an additional paragraph in the introductory words to KAM, in the auditor's report, to make explicit the reason for the inclusion of KAM. Introductory wording to KAM (in the example auditor's report proposed in ISA 700) could be:

"Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the consolidated financial statements. <u>Key audit matters are included below because they are areas identified as significant risks or involving significant auditor judgement</u>. Key audit matters are selected from the matters communicated with…"

---

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?*

AUASB Response:

Useful or Informative

(a) The 4 examples included in ISA 700 provide a reasonable guide as to the level of detail expected to be included in KAM to the extent that they provide examples of the selection criteria in proposed ISA 701 paragraph 8(a). Field test results have shown that where a KAM is similar to the examples, such as goodwill impairment, the auditors used the examples to draft their KAM.

(b) The examples communicate:

(i) *Additional information* to users of the financial statements to which they would otherwise not have access; and

(ii) Information on the auditor's focus to users.

(c) In all the proffered examples, the features that are of most value to users of the financial statements are likely to be perceived as follows:

(i) Through highlighting areas of significance to the auditor, users will be guided to:

- "significant" aspects of the entity's business which users might otherwise not recognise, and where disclosed, the entity's accounting disclosures around those aspects: and
- the entity's treatment of important, difficult and/or risky matters.

(ii) Users are provided with information that may assist them to prioritise their focus of interest.

(iii) A valuable insight to how auditors perform some of their work and the complexity of audit procedures.

(d) The intention, clearly spelt out in the shaded introductory text to the examples, is for auditors to tailor their KAM to the specific facts and circumstances of the audit and the matters discussed with TCWG. In the context of this introductory wording, the proposed amendments as a whole, and the AUASB's suggestions below, the AUASB views the examples as sufficient and useful for the purposes of the changes to the standards.

Less Useful or Informative

(e) The proffered examples relate *only* to the KAM selection criteria required in ISA 701 paragraph 8(a). Should the IAASB decide to continue with including the criteria at paragraphs 8(b) and 8(c), then examples of these scenarios would be of significant assistance to auditors.

There are no examples to illustrate KAM involving sensitive issues, including internal control weaknesses, management incompetence, risks of fraud and contentious matters that can be "politicised". <u>The AUASB strongly suggests such illustrations are provided because dealing with these "sensitive" issues is precisely where the practical implementation difficulties will lie</u>.

(f) Several stakeholders expressed concern at particular phrasing used in the example KAM. From the users' viewpoint, the choice of words may be disconcerting and may inadvertently decrease the users' level of confidence in the financial statements. Examples are:

(i) Valuation of Financial Instruments – "*We challenged management's rationale*"

(ii) Revenue Recognition Relating to Long-Term Contracts – "…*present a risk of material misstatement due to fraud*".

These 2 examples are illustrations of the wider issue of facts versus perception.

AUASB Suggestion:

The AUASB suggests new guidance material should be developed to assist auditors with determining the appropriate choice of expression when drafting KAM. Such guidance should direct the auditor to consider the *implications* and *possible perceptions* generated by their choice of expression. In circumstances where the auditor is in doubt, the views of the entity's management/TCWG should be sought.

(g) Several stakeholders expressed concern at the apparent inconsistency between the intention of the introductory paragraph to the KAM and the choice of wording in 2 of the KAM paragraphs. The last words of the introductory paragraph to the KAM section states: "…*we do not express an opinion on these individual matters*."

The AUASB acknowledges the guidance at proposed ISA 701 paragraph A41, however, the following examples taken from the illustrative example reports in proposed ISA 700, are a statement or conclusion drawn by the auditor on the specific issue and in turn may be interpreted by users to be the auditor expressing an opinion on the particular matter:

(i) Valuation of Financial Instruments: "*We challenged management's rationale for using an entity-developed model, and discussed this with* [*those charged with governance*], *and we concluded the use of such a model was appropriate*".

(ii) Revenue Recognition Relating to Long-Term Contracts: "*Based on the audit procedures performed, we did not find evidence of the existence of side agreements*".

AUASB Suggestions:

(i) The guidance in proposed ISA 701 should make clear that conclusions, and suggestions of conclusions, should be avoided in drafting KAM paragraphs.

(ii) The underlined wording above should be removed in the illustrative examples in proposed ISA 700.

(h) Proposed ISA 701, Illustration 4. The responsibilities of management section of the auditor's report states that: "*Management is responsible for preparation and fair presentation…*"

AUASB Suggestion:

As this is an example of an auditor's report for a compliance framework, the words *and fair presentation* should be removed.

---

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.*

AUASB Response:

(a) At this stage of the IAASB's development of enhancements to auditor reporting, the AUASB supports the approach in relation to KAM for entities for which the auditor is not required to provide such communication. The AUASB is not presently aware of any apparent practical considerations that may affect the auditor's ability to decide to communicate KAM when not otherwise required to do so.

(b) A number of stakeholders took the view that the underlying principles of improved auditor communications through the auditor's report apply equally to (certain) non-listed entities, especially those of public interest, and to (certain) review engagements, particularly statutory reviews of interim financial statements of listed entities.

The AUASB acknowledges that at this time the question is for national standard-setters to decide. However, in the interests of global consistency, the IAASB is encouraged to address this issue as soon as practical.

AUASB Suggestion:

In the post-implementation period, the AUASB encourages the IAASB to further consider the new reporting regime in relation to:

- Audits of public interest entities; and
- Review engagements (particularly statutory reviews of listed entities).

---

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?*

AUASB Response:

(a) The AUASB disagrees with the proposal to allow for the possibility that the auditor may determine that there are no key audit matters to communicate. The AUASB believes that the auditor should be required to always communicate at least one KAM.

(b) Regardless of the audit engagement circumstances, including "low risk" audits, the AUASB is of the view that there will always be at least one "…matter that, in the auditor's professional judgement, was of *most significance* in the audit of the financial statements of the current period". The AUASB is of the view that there will always be matters of increased audit focus, regardless of the circumstances of the audit, and accordingly, such increased audit focus would constitute a KAM.

(c) Should the IAASB allow the possibility of no KAM to be reported, entities will be provided with leverage in their discussions with auditors on whether or not a matter should be included in KAM. Placing auditors in such a position is not considered desirable by the AUASB.

(d) Should the IAASB allow the possibility of no KAM to be reported, then the proposed requirements and related guidance should be enhanced to deter auditors from inappropriate use of the exemption.

<u>AUASB Suggestions</u>:

(i) The requirement at proposed ISA 701, paragraph 13, should be improved by including the same confines as set out in guidance paragraph A47—which provides clear context to the scenario, namely: "certain limited circumstances…it is expected to be rare…"

Consideration should be given to re-wording the beginning of the requirement paragraph 13, as follows:

If, <u>in certain limited circumstances</u>, the auditor determines…

(ii) Additional guidance should be provided, including examples of such "limited circumstances".

---

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?*

AUASB Response:

(a) The AUASB supports the proposed approach to communicate KAM that are limited to the audit of the most recent financial period. The AUASB further supports the guidance material at ISA 701, paragraphs A8-A9 which provides appropriate direction for the auditor when considering prior periods.

(b) The proposed introductory wording to the KAM section of the auditor's report is not explicit about the commentary being limited to the audit of the most recent financial period. Accordingly, there is a risk that users may be confused as to why a KAM included in the previous auditor's report is not included, or commented on, in the current period auditor's report. Equally, users may not understand why a KAM in the auditor's report was not included in the previous auditor's report.

AUASB Suggestion:

Consideration should be given to additional wording in the introductory paragraph.

For example:

"Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the current period consolidated financial statements. Key audit matters are selected…"

---

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?*

AUASB Response:

Emphasis of Matter Paragraphs

(a) The AUASB supports the retention of Emphasis of Matter paragraphs (EOM) and how the concept has been addressed in the proposed ISAs.

(b) The AUASB's support is based on the following views:

(i) An EOM, as described in ISA 706, is *fundamental to users' understanding of the financial statements*. The financial statements are *the* "subject matter" and therefore, are the primary focus of user interest. Users seek information to assist in making decisions—that information is deemed to be provided by general purpose financial statements (required for listed entities).

The auditor's report adds credibility to the financial statements but is not the primary source of information for users. The auditor's report, although important, is supplementary to the main objective of both preparers and users of financial statements. A KAM is defined differently, as *matters that, in the auditor's professional judgement, were of most significance in the audit…*and importantly therefore, do <u>not</u> necessarily relate to a matter disclosed in the financial statements. To subsume an EOM into KAM equates to a change in concept and effectively removes the auditor's ability to emphasise a matter that is not defined as a KAM.

For example: proposed ISA 706 paragraph A16, describes an EOM—an uncertainty related to the outcome of a lawsuit. This is a good example of where an emphasis is appropriate, yet the auditor may not have spent much time or exercised much judgement on this contingent liability, and therefore does not consider the matter to be of "most significance in the audit".

(ii) To remove the EOM concept will result in differing reporting frameworks for auditors of listed entities and auditors of entities where inclusion of KAM is not required. This situation will be confusing for users, especially those who examine the financial statements of listed entities, public interest entities and large non-listed entities. The AUASB does not support users having to address inconsistent auditor's reports depending on the nature of the audited entity.

(iii) Inconsistency of reporting will result in unnecessary difficulties for group auditors receiving cross-border clearances from auditors of components that are not listed.

(c) The AUASB does not support permitting the auditor to determine the placement of an EOM paragraph (proposed ISA 706 paragraphs A15 and A16).

To locate an EOM paragraph *after* the KAM paragraphs incorrectly suggests a lower priority of importance in the context of user information needs. Such placement is contradictory to the definition of an EOM…*fundamental to users' understanding*.

<u>AUASB Suggestions</u>:

(i) The AUASB strongly suggests that an EOM must be clearly distinguished from a KAM.

(ii) Proposed ISA 706 should be amended to direct auditors to position *any* EOM paragraph directly after the Basis for Opinion paragraph and before any other paragraphs with the exception of going concern paragraphs reported under ISA 570 (i.e. where a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern, exists).

Other Matter Paragraphs

(d) The AUASB supports retention of Other Matter paragraphs (OM) and how the concept has been addressed in the proposed ISAs.

(e) The AUASB's support is based on the following views:

The definition of an OM differs from that of a KAM. Therefore, to subsume an OM into KAM:

- Equates to a change in the concept of an OM and effectively removes the auditor's ability to report a matter that is not defined as a KAM.

- Results in differing reporting frameworks that require users to address inconsistent auditor's reports depending on the nature of the audited entity.

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 continue as a going 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?

AUASB Response:

(a) The AUASB supports the proposed statement relating to the appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements.

(b) The AUASB supports the proposed statement as to whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern.

(c) The AUASB believes that the reporting proposals do have the potential for users to misunderstand or misinterpret, thereby widening the "expectation gap".

In order to improve the informational value of the auditor's report, the AUASB makes the following comments and suggestions:

(i) The proposed standards and the illustrative auditor's reports in proposed ISA 700 and ISA 570, do not explicitly state that: management, or TCWG, as appropriate, is/are responsible for determining the appropriateness of using the going concern basis of accounting.

The responsibilities of management, or TCWG, are implicit in the statement under the "responsibilities of management" section that refers to preparation and presentation under IFRS. However, so too have the auditor's responsibilities been implicit in this area, however, the proposals are for the auditor to make explicit statements without commensurate statements about the responsibilities of management or TCWG.

AUASB Suggestion:

The AUASB is of the view that the most appropriate location of a statement about the responsibilities of management/TCWG regarding the going concern basis of accounting, is in the financial statements or any directors' declaration (or equivalent).

However, in the absence of changes to the financial reporting framework, the AUASB suggests an explicit statement about the responsibilities of management or TCWG, as appropriate, is included in the auditor's report to complement the proposed new conclusions and statements required of the auditor. In the interests of improving communications, users would surely benefit from a clear message as to which party is actually responsible for use of the going concern basis of accounting.

The responsibilities of management/TCWG relating to the use of the going concern basis of accounting would best be included in the responsibilities of management section of the auditor's report. Suggested wording for consideration:

"Management/TCWG is/are responsible for the preparation and fair presentation of these consolidated financial statements, including the appropriateness of the going concern basis of accounting, in accordance with IFRSs…"

(ii) In the interests of improved information for users, consideration should be given to requiring auditors to include a statement as to the period covered by:

(a) management/TCWG when determining the appropriateness of using the going concern basis of accounting; and

(b) the auditor’s assessment thereof.

In Australia, there is a long-standing requirement in the Auditing Standards, for auditors, and management, to consider the period from the date of the auditor’s report to the expected date of the next auditor’s report – a stronger requirement than in the equivalent ISA that requires the auditor’s assessment to cover the period to the next financial balance date.

AUASB Suggestion:

Consideration should be given to amending ISA 570 to require the period of management’s, and the auditor’s, consideration of going concern to be disclosed in the auditor’s report. This requirement could be structured so as to include the period covered only if that period does *not* coincide with the date of the financial statements.

(iii) ISA 570 focusses on the existence of a material uncertainty and is silent on “mitigating circumstances” which may exist when an apparent going concern issue, such as a deficiency of shareholder funds, is present but due to mitigating circumstances does *not* result in a material uncertainty. The implicit message is that the auditor would modify the opinion if mitigating circumstances, such as a parent entity guarantee, were *not* sufficiently disclosed so that the financial statements did *not* present fairly.

ISA 570, Illustration 3, the example adverse opinion auditor’s report, is precisely where misunderstanding and misinterpretation is likely to occur. The basis for the adverse opinion refers to the entity’s inability to re-negotiate or obtain replacement finance and is considering filing for bankruptcy…yet the auditor states that the going concern basis of accounting is appropriate. The auditor’s conclusion can only be made if there are “mitigating circumstances” that the auditor considered adequate to conclude that management *does* have *a realistic alternative* to liquidation. However, the financial statement users are left guessing as to what the mitigating circumstances, or other reasons, might be.

AUASB Suggestion:

The AUASB suggests that ISA 570 be amended to require auditors to include sufficient information in the auditor’s report supporting the appropriateness of the auditor’s assessment of the use of the going concern basis of accounting by management/TCWG. This requirement would be limited to circumstances where either the financial statements or the auditor’s report (for example, in an EOM paragraph), provide information indicating a going concern issue might exist and yet the auditor concludes the going concern basis of accounting is appropriate.

(iv) Proposed ISA 570 paragraph 21 (b) explains the sequence of concepts:

…*material uncertainty*, related to events or conditions that—may cast *significant doubt on the entity’s ability to continue as a going concern* and— therefore that it may be *unable to realize its assets and discharge its liabilities* in the normal course of business.

However, the *consequences* of a going concern issue, as stated in paragraph 21(b), are not included in the proposed wording of the auditor’s report.

AUASB Suggestion:

In the interests of enhanced information for users, the AUASB suggests additional wording in the going concern section of the auditor's report when a going concern issue exists. Suggested wording for proposed ISA 570:

Illustration 1

"…indicate the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore that it may be unable to realize its assets and discharge its liabilities in the normal course of business."

Illustrations 2 and 3

"…a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore that it may be unable to realize its assets and discharge its liabilities in the normal course of business, has been identified."

(v) Under the (Australian) *Corporations Act 2001*, directors are required to express a declaration about the company's *solvency*. The declaration is combined with the financial statements to create the "financial report" which is the subject matter of the auditor's opinion.

For users, the proposed auditor reporting on going concern may become confusing in light of the directors' solvency declaration.

AUASB Suggestion:

Consideration should be given to providing guidance (at a minimum) in ISA 570 on how to word the going concern section of the auditor's report when a solvency declaration, or similar, accompanies the financial statements.

(vi) A number of AUASB stakeholders perceived the wording of the illustrative going concern section as difficult to understand because the language used is too complex ("technical") for the "other than sophisticated" user. The terms "solvency", "liquidity", "going concern" and "going concern basis of accounting" are not well understood.

AUASB Suggestion:

Additional guidance around the terminology of this area should be provided in ISA 570 which would at least provide a point of reference for users and practitioners.

(d) Several stakeholders were concerned that the proposed standardised wording about going concern may cause users to become over-familiar with this section of the auditor's report and therefore miss the auditor's information on a material uncertainty when it is included. The consensus view is that reporting *by exception*, as is the case with the existing EOM, is a far more effective approach.

AUASB Suggestion:

Reporting on going concern should be required by exception only.

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?*

AUASB Response:

(a) The AUASB supports the explicit guarantee statement *but* not exactly as proposed.

(b) The AUASB disagrees with the proposal that the guarantee statement should be limited to auditor's reports on engagements where there are no going concern issues. The proposals contained in ISA 570 make clear that the guarantee sentence is dropped when material uncertainties relating to going concern exist. The AUASB is unclear as to why this is proposed because the meaning of the sentence does not change due to the existence, or otherwise, of a material uncertainty?

AUASB Suggestion:

The AUASB suggests that the guarantee sentence is included in the auditor's report in *all* circumstances other than when the auditor issues a disclaimer of opinion or concludes the entity is not a going concern and therefore the going concern basis of accounting is not appropriate.

(c) The AUASB disagrees with the proposal that the auditor should make a representation on behalf of management, who are not co-signatories to the auditor's report. Furthermore, the proposals are silent, in this context, on the role of TCWG. Omitting reference to TCWG, may invite users' misunderstanding as to whether TCWG have a higher level of responsibility regarding going concern or have no responsibility regarding going concern.

AUASB Suggestions:

(i) The AUASB suggests that the proposals are amended so that ISA 570 requires the auditor to:

- Determine the appropriate level of entity personnel responsible for assessing going concern;
- Request and obtain representations from that level of entity personnel to enable reference to them to be included in the guarantee sentence in the auditor's report; and
- Disclose that such representation has been obtained.

(ii) In addition, the standard should provide adequate guidance to assist auditors when no such representation is forthcoming.

---

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?*

AUASB Response:

(a) The AUASB supports disclosure of the sources of independence and other ethical requirements.

(b) The AUASB believes that there are no significant difficulties in adopting the proposed amendments in Australia that cannot be overcome by some level of editorial adjustments that do not lessen the proposed requirements.

(i) In Australia, auditors are required by the *Corporations Act 2001* to make an independence declaration in the auditor's report. The wording for a single listed company is:

"*Independence*

In conducting our audit, we have complied with the independence requirements of the *Corporations Act 2001*. We confirm that the independence declaration required by the *Corporations Act 2001*, which has been given to the directors of ABC Company Ltd., would be in the same terms if given to the directors as at the time of this auditor's report.*****

Footnote * Or, alternatively, include statements (a) to the effect that circumstances have changed since the declaration was given to the relevant directors; and (b) setting out how the declaration would differ if it had been given to the relevant directors at the time the auditor's report was made."

(ii) The existing reference to compliance with relevant ethical requirements included in the auditor's report (under the heading Auditor's Responsibilities) is:

"…We conducted our audit in accordance with Australian Auditing Standards. Those standards require that we comply with relevant ethical requirements relating to audit engagements…"

<u>AUASB Suggestion</u>:

The AUASB suggests that proposed ISA 700 be amended to explicitly enable national standard setters to make necessary amendments to the proposed wording in relation to independence and compliance with Ethical Standards, to accommodate national circumstances, and that such modifications are conditional on not reducing the equivalent ISA requirements.

(c) The AUASB acknowledges the point made in paragraph 92 of the Exposure Draft and concurs that an extensive list of the sources of ethical requirements may be confusing, and in multinational group audit situations, identifying all sources may become unduly complex.

<u>AUASB Suggestion</u>:

The standard could be amended—*only* in the case of a multinational group; *only* in relation to component entities; and *only* where it is impractical to do otherwise—to permit a generalised description of the sources of ethical requirements in the component entities' jurisdictions), for example:

"We are independent of the Group within the meaning of [*indicate relevant ethical requirements or applicable law or regulation* <u>*and the relevant ethical requirements relating to audit engagements of component entities in*</u> <u>(name countries)</u>]

---

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?*

AUASB Response:

As in the past, disclosure of the engagement partner's name is current practice in Australia and is also required by law. The AUASB, therefore, does not foresee any issues, or perceived difficulties, arising from this proposed requirement in Australia.

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?*

AUASB Response:

(a) The AUASB supports the following proposed changes to ISA 700 and the articulation of requirements:

(i) The improved description of the responsibilities of the auditor and key features of the audit.

(ii) The provision for the descriptions of auditor responsibilities and key features of the audit to be re-located in either an appendix or the website of an appropriate authority.

(iii) Reference to whom in the entity is responsible for overseeing the entity's financial reporting process.

(iv) Flexibility for national standard-setters to determine placement of auditor's communication of other reporting responsibilities (Report on Other Legal or Regulatory Requirements).

The AUASB acknowledges that the proposals require clear differentiation, however takes the view that the enhanced auditor reporting requirements will result in a significant increase in the amount of detail in the auditor's report and accordingly other reporting responsibilities should be presented in a clearly separate section of the auditor's report.

(b) The AUASB disagrees with the following proposed changes to ISA 700:

The second paragraph of the example auditor's report currently located under the heading "Opinion". The paragraph is a statement of process and identification; it is not, wholly or in part, an opinion.

AUASB Suggestion:

The AUASB suggests relocating the second paragraph currently under the heading "Opinion" to become the first paragraph under the heading: "Basis of Opinion". The relevant paragraph is:

We have audited the financial statements of the Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

(c) Appendix illustrations 1 and 2. The last sentence in the shaded text under "Key Audit Matters" ends with the words: "*…and are intended to be consistent with the disclosures in the entity's financial statements*".

These words may cause confusion because of an apparent contradiction with ISA 701 paragraph 8. The ISA 701 requirements make clear that KAM do not necessarily refer to disclosures in the financial statements. For example, paragraph 8(c) refers to *a significant deficiency in internal control* that caused a significant modification to the auditor's planned approach.

Accordingly, consideration should be given to amending the shaded text in the two illustrative auditor's reports in ISA 700 to, for example:

…and are intended to be consistent with ~~the~~ any related disclosures in the entity's financial statements.

or

…and are intended to be consistent with ~~the~~ disclosures, if any, in the entity's financial statements.

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?*

AUASB Response:

(a) The AUASB disagrees with the IAASB's proposal to not mandate the ordering of the auditor's report sections.

The AUASB supports mandating the ordering of sections in the auditor's report as this facilitates global consistency, expectation and familiarity of the auditor's report layout for both users and auditors.

In the absence of mandating the ordering of sections in the auditor's report, there is a risk that ordering may be used to emphasise certain positive information, such as an unmodified opinion, and de-emphasise less positive information, such as an emphasis of matter or unfavourable KAM commentary.

(b) It should be noted in contrast, that the preparer group of AUASB stakeholders was particularly supportive of the IAASB's proposal to not mandate the ordering of sections of the auditor's report to enable flexibility of reporting

(c) The AUASB supports the requirements in proposed ISA 700 paragraphs 46–48, when reference is made to the ISAs, to address auditor's reports prescribed by law or regulation.

***

Attachment 2

Additional Comments for the IAASB's Consideration

These additional comments for the IAASB's consideration are included separately as **Attachment 2** because they do not relate directly to the specific questions asked by the Exposure Draft (see **Attachment 1**).

Key Audit Matters (KAM)

1. The IAASB proposals presently do not deal with situations where management/TCWG disagree with the inclusion of a KAM or with the auditor's description of a KAM. Furthermore, the proposed standards are silent on how the auditor should deal with situations where an entity's management/TCWG request the auditor to *not* include a KAM that the auditor judges as warranting inclusion.

   Consideration should be given to providing additional requirements and guidance to assist the auditor to reach an appropriate conclusion when faced with these circumstances.

2. The proposals currently do not provide guidance to the auditor on how to deal with uncorrected, or corrected errors, audit adjustments or materiality when determining KAM—are they to be included in the auditor's considerations and if so, how?

   The preparer group expressed a view that a KAM that has been resolved should be described as such in the KAM paragraph.

3. The proposals presently do not provide guidance on whether or not KAM with similar characteristics can be aggregated. For example, when a *significant risk* and *significant auditor judgement* are separate matters to be reported but relate, albeit differently, to the same account balance.

4. A number of stakeholders consulted by the AUASB believed that the KAM examples were overly simplified and provided little added value to the decision making of users, particularly investors. Based on the proposed examples in ISA 700, some predicted that KAM inclusions in the auditor's report will, in time, become boilerplate. It is perceived by some, that auditors will seek a measure of uniformity in their KAM disclosures because of their traditional risk-averse nature and professional indemnity reasons.

5. In the context of KAM, the preparer group of AUASB stakeholders:

   (a) Saw the KAM as the critical component of the proposed changes.

   (b) Did not raise any issues with the 3 criteria for determining KAM.

   (c) Were particularly supportive of

      (i) Replacing "auditor commentary" with KAM. The former concept allowed auditors to become first originators of information about the entity. Albeit reduced, there is still concern over this issue.

      (ii) KAM being selected from matters discussed with TCWG.

      (iii) KAM initially applicable to listed entities only.

   (d) Expressed concerns that the significant professional judgement required of the auditor in drafting KAM, could create the potential for disagreements between management/TCWG and the auditor over the nature and disclosure of KAM, as well as any related financial statement disclosures.

      Necessary discussions would involve senior members of each organisation and accordingly would incur time and money costs and the likelihood of significant delay in finalising the annual reporting requirements. The practitioner groups also expressed this view.

(e) Expressed concern over the *effect* or *user interpretations*, of differing KAM between auditors of entities in the same industry.

(f) Questioned why the auditor is not required to make a statement as to whether a KAM relates to a material or immaterial account balance; and if material, that the matter has been satisfactorily resolved.

There is a potential for users not to understand that a KAM relating to an immaterial account balance would *not* affect the auditor's opinion on the financial statements as a whole. For example, a KAM relating to auditor difficulties in auditing the understatement of a class of liabilities, the materiality of which can only be determined once the audit procedures are complete.

(g) Suggested that over time, the KAM section will become much more detailed—a complete listing of everything the auditor found during the audit process and reported to TCWG. Auditors may well become motivated to this detailed disclosure approach in order to cover themselves from having to justify, particularly to the Regulator, why a matter was, or wasn't, included in the KAM section of the auditor's report. There is, therefore, a potential for the auditor's report to become significantly longer than necessary to meet user needs.

(h) Questioned how users might interpret the new KAM paragraphs—will the first KAM paragraph be perceived as more important than the next, and so on? Guidance was requested on this point.

6. Whilst broadly supportive of the need for improvements to auditor reporting, Australian practitioners were, in the main, quite concerned that the proposals have the potential to cause significant increased exposure to their legal liability. This issue is particularly relevant in Australia where Auditing Standards are legislative instruments and are therefore legally enforceable for audits (including listed entities) conducted in accordance with the *Corporations Act 2001*.

For example, in the event of a listed entity collapse, will the auditor be required to justify:

(a) Why a particular matter documented in the audit file was *not* communicated through the auditor's report (say, in the KAM section);

(b) Whether a matter that was communicated through the auditor's report was (deemed to be) incomplete in its informational content or inappropriately described; or

(c) Whether a KAM, perceived as an "amber warning" was not an EOM or a modification to the opinion.

This issue will certainly consume significant time and cost as firms' risk management personnel and the legal profession will undoubtedly be consulted in the formulation of future auditor's reports. Uncertainty as to the Regulator's response to KAM was clearly seen as an issue by the practitioner groups.

7. Some AUASB stakeholders supported mandating KAM for audits of *all* entities that are required to prepare general purpose financial reports (GPFR). The logic was that KAM is supposed to provide useful information to users who cannot obtain that information otherwise (such as in the case of listed entities) which is the same circumstance for any users of GPFRs, regardless of whether or not the entity is "listed".

Going Concern

8. One preparer group of AUASB stakeholders were not overly troubled with the proposed inclusions in the auditor's report in relation to going concern. They were confident that the financial reporting framework (IFRS) requirements in relation to "material uncertainty" were sufficient to ensure proper disclosure. Any undisclosed material uncertainties identified by the auditor would be resolved with the auditor and properly disclosed in the notes to the financial statements in preference to a modified auditor's opinion. The auditor's report wording on going concern would therefore very quickly become boilerplate and its usefulness questioned, especially if users' familiarity with the section caused them to avoid reading it.

Other Information

9. The preparer's group of AUASB stakeholders expressed support for the removal of preliminary announcements and prospectuses from the scope of the proposed revised ISA 720 *The Auditor's Responsibilities Relating to Other Information*. However, this group perceived an increase in costs resulting from the revised standard, as auditors will inevitably spend more time on these procedures due to the proposed explicit disclosure in the auditor's report.

   Concern was also expressed about the issue of timing. A number of documents, which comprise the financial reporting package, such as the directors' report, are ordinarily not complete at the time the auditor's report is signed.

Other Comments from Investors

10. The following selection of points is included in this submission to inform the IAASB of valuable input received from investors consulted by the AUASB:

    (a) Additional information is always welcome, the timeliness of the additional information from an investment performance and monitoring perspective is critical. Whilst the audit report may confirm issues within an entity that occurred during a period, the receipt of the additional information via the audit report after period end would not be timely from an investment performance and monitoring perspective.

    Investment analysts would continue to rely on the regular reporting and information provided by investment managers and obtained from the entity's continuous disclosure reporting, as well as the ability to liaise with the investment managers during the period to monitor and manager performance. However, the financial statements and enhanced content of the audit report could assist in subsequently validating the accuracy of the regular investment manager reporting, albeit after period end.

    (b) The big investor issue, from a financial reporting perspective, relates to the increasing disparity between official, reported financial results/statements (prepared under the accounting standards) and what the entity, industry or investment community deem relevant. Accordingly, many investment decisions are made using unaudited adjustments or presentations by the entity, without being able to properly reconcile these numbers with the reported numbers.

    (c) There is a need for auditors to be careful about the length of the auditor's report. If the report is considered by users to be too long, it becomes questionable as to whether the auditor's report will actually be read in full/understood. In addition, care needs to be taken to avoid the auditor's report becoming a "giant disclaimer" due to the auditor's perception that non-disclosure of a matter could lead to legal action against the auditor.

    (d) Some investors, such as retirement funds, are increasingly investing directly in non-listed entities or in 'fund of funds', which themselves invest in non-listed entities. Accordingly, the requirement to include Key Audit Matters in the auditor's report would be useful for these non-listed entities where there is a lack of marketplace information.

***