



30 June, 2015

Merran Kelsall  
Chairman & CEO  
Auditing and Assurance Standards Board  
By email: mkelsall@auasb.gov.au

Dear Merran

**SUBMISSION: Exposure Draft 01/15 - Audit Report Enhancements**

We are pleased to provide comments from an investor perspective on *ED 01/15: Reporting on Audited Financial Reports – New and Revised Auditor Reporting Standards and Related Conforming Amendments* ('audit report enhancements').

**About Regnan**

Regnan – Governance Research & Engagement Pty Ltd was established to investigate and address environmental, social, and corporate governance related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors with \$61 billion invested in S&P/ASX200 companies (at 30 June 2014). This approximates 4.3% of this index. These institutions include Advance Asset Management; Commonwealth Superannuation Corporation; BT Investment Management; Catholic Super; Hermes Equity Ownership Services (UK); HESTA Super Fund; Local Government Super; NTGPASS; Vanguard Investments Australia; VicSuper; and the Victorian Funds Management Corporation.

**Our support**

We are supportive of all of the proposals in ED 01/15, including:

- For listed entities, new section to communicate key audit matters (KAM) being those matters that were of most significance in the audit.

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- Opinion section required to be presented first.
- Enhanced auditor reporting on going concern.

Below we offer a number of observations on expected benefits and costs.

### **Enhanced communications – investors, investee boards and auditors**

There is a long history of constructive investor-investee engagement in Australia. For example, Regnan’s work in listed entity engagement on behalf of institutional investors commenced in 2001<sup>1</sup>.

However, in our experience, this investor-investee dialogue rarely extends to financial statement assurance. Other opportunities for investor ‘voice’ on assurance (such as the shareholder vote on company auditor appointment and requirement that the auditor attend the AGM) are also little used.

We perceive a lack of engagement by financial market participants in the detail of financial assurance. There is some understanding among financial market participants of assurance’s limits and a tendency to discount the value that it adds. This tendency to discount the value of assurance is compounded by the fact that financial assurance focusses on a report that contains little new information (lagging release of financial results) and, thus, has small market sensitivity.<sup>2</sup>

In our view, this discounting is unjustified. Assurance of the key periodic report plays a critical role in ‘confirming, and hence disciplining’<sup>3</sup> other disclosures to the market. The accuracy of preceding unaudited disclosures is tested and proved by their consistency with subsequent audited accounts. Further, assurance adds considerable value by testing the underlying systems and processes that produce both the audited statutory report and other financial disclosures.

The proposed audit report enhancements provide a useful starting point for dialogue between investors and investee boards on assurance. It is through such conversations that the expectation gap could be narrowed and greater understanding be built among investors of the value that external assurance adds.

In this regard we note the experience with executive pay reform over recent years - another key area of concern identified in the analysis of the global financial crisis. Reforms in Australia focussed on transparency (enhanced pay disclosure requirements) and investor voice (‘say on pay’ votes) – similar to the approach proposed for audit report enhancements. Executive pay reforms have been effective in dramatically increasing the extent of investor / investee dialogue as well as the quality of disclosure.

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<sup>1</sup> As the BT Governance Advisory Service.

<sup>2</sup> Studies which have addressed the market sensitivity of audited accounts are summarised in Ball, Ray, ‘Accounting Informs Investors and Earnings Management is Rife: Two Questionable Beliefs’ (May 15, 2013). *Accounting Horizons*. Available at SSRN: <http://ssrn.com/abstract=2211288> or <http://dx.doi.org/10.2139/ssrn.2211288>

<sup>3</sup> Ibid, p4.

### **Supporting professional scepticism**

We consider it possible that by increasing transparency the audit report enhancements may shift dynamics between the auditor, management and the board. Additionally, enhanced disclosure is likely to bring investors closer into this relationship – via discussions with investee boards.

The experience with executive pay again may be instructive. For pay, investor-investee board dialogue has empowered boards to challenge management and reduced the influence of remuneration consultants.

We consider any such shift would likely support professional scepticism.

### **Increased attention and enhanced disclosures**

We understand that the comments on KAM are not intended to be similar to (or a lesser category of) emphasis of matter. Nonetheless, we consider there is a grey area where an item presents assurance challenges but does not lead to emphasis or qualification and that such would be KAM. We consider it likely that these matters will receive greater focus from all those involved in the assurance process via the audit report enhancements proposed and, as a result, be better understood by stakeholders.

### **Benefits would be undermined by standardisation**

We understand that the intention is for the communication of KAM to be entity specific. We consider any tendency toward standardised ('boiler plate') disclosures would undermine the intention behind the proposals and significantly reduce potential benefits.

We suggest attention to this matter in particular both in implementation and in reviewing effectiveness. We also suggest alertness to potential unintended consequences.

### **Costs expected to be low**

In our view, any cost to comply with the new requirements should be small, especially after the first year (which may include some 'set up' costs). The matters to be communicated in the assurance statement are likely to be drawn from the management report. Little additional effort should be required to select and communicate these for a public audience.

We do not consider the additional disclosure should entail any change to the assurance work effort where a robust assurance process is already in place. If the additional transparency requirements do lead to additional assurance effort, then the additional costs are likely to come with much greater additional benefits from an enhanced assurance, rather than merely enhanced disclosure.

The minimal foreseeable additional costs are far outweighed by the likely benefits, not merely to users of each report, but to markets more generally from increased confidence in the assurance process.



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We thank you for the opportunity to provide our perspective.

Sincerely

A handwritten signature in black ink, appearing to read "Alge".

Alison George  
Head of Governance

**About Regnan**

Regnan – Governance Research & Engagement Pty Ltd was established to investigate and address environmental, social, and corporate governance related sources of risk and value for long term shareholders in Australian companies. Regnan was launched in 2007 having operated previously as the BT Governance Advisory Service. It is owned by institutional investors: BT Investment Management and Commonwealth Superannuation Corporation (CSC) (formerly ARIA).