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Financial Reporting Council

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The International Auditing and Assurance Standards Board

Re: Invitation to Comment: Improving the Auditors Report

Dear Mr Gunn

I refer to the Invitation to Comment issued by the International Audit and Assurance Standards Board (IAASB) in June 2012 entitled 'Improving the Auditor's Report'.

I am pleased to attach a submission by the Financial Reporting Council (FRC). I would like to thank you for giving us an opportunity to comment on your proposals.

The FRC is currently conducting a number of audit quality projects as part of its strategic advice role, of which a review of the auditor commentary is one component. The FRC Audit Quality Committee has been specifically tasked with assisting the FRC in providing advice on audit quality to the Australian Government. The Committee commissioned an online survey of members of the Australian Shareholders Association on perceptions of the usefulness of the audit reports for retail shareholders in September 2012, to inform the FRC response to the IAASB ITC. A summary of the results of this survey are at [Attachment A](#).

Please feel free to contact me or the FRC Secretary (frcsecretary@treasury.gov.au) should you have any queries regarding the FRC submission.

Yours sincerely

A handwritten signature in cursive script that reads "Lynn Wood".

Lynn Wood
FRC Chair

SUBMISSION OF THE AUSTRALIAN FINANCIAL REPORTING COUNCIL ON THE IAASB INVITATION TO COMMENT ‘IMPROVEMENT TO THE AUDITOR’S REPORT’

Summary of Recommendations

The recommendations in this submission may be summarised as follows:

- The Australian Financial Reporting Council (FRC) supports the development of the auditor commentary and believes that the auditor commentary may be an important tool for communicating key information to users of financial reports. The challenge will be in providing meaningful information to users and avoiding boilerplate disclosure. A survey of retail shareholders conducted for the FRC identified that any material uncertainties in relation to going concern are of particular interest. A concern about major differences between book values and market values has also been suggested for review.
- The FRC believes it is important that the users of financial reports understand the role and responsibility of the audit.
- The FRC supports the industry’s attempt at self-regulation to better communicate the value of audit and believes that there is merit in relocating the auditor’s opinion to the beginning of the auditor’s report. The FRC notes that the ITC is one element of a broader push towards audit regulation internationally that the IAASB can address.

Specific reforms to the audit reporting framework must be considered in the context of improving market stability and accountability more broadly. As this is one of a number of mooted changes to the audit framework from various sources, we believe that it is important that the IAASB consider the systemic effects of these modifications on the whole financial reporting process. In particular, it is important that changes do not result in an over-regulated system or a system in which the parts are in conflict.

Overview

The FRC is pleased to make a submission to the IAASB public consultation process. The FRC is the peak body responsible for overseeing the effectiveness of the financial reporting framework in Australia. Its key functions include the oversight of the accounting and auditing standards setting processes for the public and private sectors, providing strategic advice in relation to the quality of audits conducted by Australian auditors, and advising the relevant Australian Government Ministers on these matters.

The FRC monitors the development of international accounting standards by the International Accounting Standards Board (IASB) and auditing standards by the IAASB, works to further the development of a single set of accounting and auditing standards for world-wide use and promotes the adoption of these standards.

The FRC has a wide range of stakeholders including a broad spectrum of preparers and users of financial reports, the Australian Government, State and Territory Governments, and other government bodies such as standard setters and regulators. Key stakeholder bodies are represented on the FRC as Members. In addition, the Australian and New Zealand Governments have established cross-appointment arrangements to promote closer economic relationships between the two countries. The FRC accordingly has a New Zealand representative as one of its members.

Australia was one of the early adopters of International Financial Reporting Standards (IFRS) in 2005 – and this is because we recognised early on, that with the current pace of globalisation, the movement to a global set of accounting standards is a logical transition. Australia’s auditing standards have been harmonised with International Standards on Auditing (ISAs) since the mid-1990s. More recently, since the clarity revision of ISAs in 2009, Australian Auditing Standards have been converged with ISAs. In addition, the Australian Accounting Professional and Ethical Standards Board (APESB) use the pronouncements of the International Ethics Standards Board for Accountants (IESBA) to develop Australian standards consistent with those issued by the international body.

The FRC has decided to provide a general response, with particular detailed comments to be provided by other Australian organisations, with specific interests in the requirements of particular stakeholders. These include stakeholders such as the Auditing and Assurance Standards Board (AUASB), professional accounting bodies and the Group of 100, which represents Australia’s senior finance executives.

As noted above, the FRC’s Audit Quality Committee (AQC) is specifically tasked with assisting the FRC to provide advice to the Australian Government on audit quality. To help inform the FRC response to the IAASB ITC, the AQC commissioned an online survey of members of the Australian Shareholders Association (ASA) a member group of retail shareholders. The survey sought to understand views about the usefulness of the auditor’s reports for retail shareholders in September 2012. A summary of the results of this survey are at Attachment A.

Overall Consideration

The FRC supports the IAASB’s ongoing interest in improving audit quality at the international level through initiatives such as the proposed improvements to the auditor’s report. The FRC also supports changes to improve the usefulness and relevance of the auditor’s report.

However, the FRC believes that care must be taken to ensure that information included in the auditor’s report remains meaningful to users rather than simply increasing the quantum of information required to be disclosed by audited entities or the auditors. Accounting Standards currently require preparers of financial reports to provide further detail where required if the existing reporting requirements are “insufficient to enable users to understand the impact of a particular transaction, other events and conditions on the entity’s financial position and financial performance” (AASB 101 clause 17(c)). As such, additional audit reporting requirements may duplicate and increase the existing compliance burden on Australian businesses.

The FRC believes that improving audit quality requires a coordinated effort by both the international bodies in developing improved standards and guidance, as well as the national regulators to promote and support means by which auditors can effectively communicate meaningful information to users of financial reports of the audited entity.

Respondents to the FRC survey on the usefulness of the auditor's report noted that they were generally comfortable with the information currently included in the auditor's report; however some respondents support the inclusion of an explicit statement as to whether or not any material uncertainties in relation to going concern have been identified.

Auditor Commentary

The FRC believes that the auditor commentary may be an important tool for communicating key information to users of financial reports. Almost one third of respondents to our survey supported this position, revealing that the auditor's report was one of their most useful sources of information. In terms of further improving the auditor's report through enhanced auditor commentary, survey respondents especially supported the inclusion of references to significant or unusual transactions and contentious matters noted during the audit.

However, the FRC believes that care should be taken to ensure that the contents of the auditor commentary remain within scope of the auditor's existing role. The possible expansion of the audit role through the auditor commentary risks increasing the liability of auditors at a time when auditors are being held to account for decisions made by directors and management. In Australia, recent experience with various failed public companies ignited public debate about the role of audit in preventing corporate collapse, despite the contributing roles of the directors, management and poor business strategy more broadly. Audit reform may have the unintended consequence or the perception of increasing the role of audit by increasing the importance of the auditor commentary. This would not address problems associated with directors and management not meeting their existing statutory obligations in relation to financial statement preparation and entity management. The FRC supports the proposal to only require auditor commentary for public-interest audits. Tiered auditing requirements ensure that large and public interest entities have an appropriate level of oversight without increasing the compliance burden on smaller entities. In the Australian context, nearly 98% of companies are small proprietary companies, small companies limited by guarantee or not-for-profits that are subject to reduced or no reporting requirements. Care also needs to be taken in relation to whether public sector entities might be included in the proposals for various reasons and, if so, how. This is because auditors-general ordinarily prepare descriptive long-form reports to Parliament on the outcomes of their annual financial audits, which are separate to the auditor's reports that accompany the financial reports of public sector entities. Another consideration is whether all public sector entities should, as a matter of course, be considered to be public interest entities.

Going Concern/Other Information

The FRC believes that it is important that the IAASB carefully considers the purpose of expanding the auditor commentary, and to clearly distinguish between providing information otherwise not included, and highlighting significant information contained elsewhere in the financial report.

Improvements to the use of audit and accounting concepts such as ‘going concern’, ‘emphasis of matter’ and ‘areas of significant auditor effort’ need to be carefully considered in the context of the broad range of users of financial reports. The FRC believes that these concepts should be clearly defined in the auditor’s report, as different users of financial reports have widely divergent understandings of these concepts. Respondents to the FRC survey reflected this, demonstrating varied understandings of key audit concepts, with just over half claiming to understand the ‘going concern’ concept, whereas only 13 per cent claimed to understand the use of ‘emphasis of matter’. We understand that the IAASB has reached out to the IASB seeking better definition and guidance in relation to the accounting terms in the accounting standards. To this end, we believe that, ideally, those charged with governance should be required by IFRS to make an explicit statement in the notes to the financial statements, as distinct from the present implicit assumption, that the financial statements have been prepared on a going concern basis and that the entity is a going concern as at reporting date. It would also be helpful for the IASB to consider whether such a statement should highlight that the financial statements have been prepared on a “going concern” basis, or highlight solvency risks more broadly.

Clarifications and Transparency

The FRC believes that users of the financial reports should have a clear understanding of the role and responsibility of the auditor. This should not itself add to the complexity of reading such reports, and not be overly wordy, including perhaps tables or diagrams if useful.

The survey results reflect the degree to which clarity about the role of the auditor is needed. While a majority correctly identified the role of the auditor as forming an opinion as to whether the financial reports had been prepared according to the relevant accounting standards, approximately half of the survey respondents also noted that the role of the auditor was also to ensure that the entity was financially ‘healthy’, that the financial reports are ‘100% correct’ and to prevent serious mismanagement leading to corporate collapse. To the extent to which users believe that the auditor is responsible for ensuring the health of the audited entity, auditors can be seen to have assumed responsibility for management decisions in the preparation of the accounts.

The FRC believes that users should have easy access to descriptions of the respective roles of key actors in the audit, to better understand the scope and role of the auditor. Over the longer-term, a review of the auditor’s report is an opportunity to review the means by which the roles of those involved in the development of financial reports are communicated to users. As almost two thirds of the survey respondents stated that the auditor’s report does not provide sufficient information about what the auditor is

required to do, there is potential for the auditor's report to improve communication with users. Such communication could be improved through the provision of standardised material describing the respective roles of auditors, directors and management in an appendix to the annual report, a proposal that was overwhelmingly supported by survey respondents.

Form and Structure

The FRC believes that it is not necessary to overly regulate the order and structure of the auditor's report any more than currently. Additional auditor commentary is designed to reveal areas of significant audit interest in relation to the audited entity. As such the inclusion of additional commentary is expected to result in different auditor's reports between audited entities. This position is supported by over 80 per cent of survey respondents, who noted that they had no problems with auditor's reports becoming less standardised where additional auditor commentary is included.

Equally, however, we believe that too much latitude in this respect runs the risk that the objective of consistency and comparability across jurisdictions may not be attained. It is worth noting that in Australia, the relevant auditing standard ASA 700 directly follows the requirements and form of ISA 700, other than the additional insertion of local regulatory requirements to conform to the *Corporations Act*.

More broadly, rather than focus on the form of the information, it is important that auditor's reports effectively communicate key information to users. Survey respondents have expressed frustration at what they consider to be increasingly "bland", "useless" and "lengthy" auditor's reports when many are seeking a clear, plain language account of the position of the audited entity. The development of further auditor's report requirements risks increasing audit disclosures without improving the communication of key audit information to users. At its extreme, the volume of disclosures may make it increasingly difficult for non-sophisticated users to understand this information.

Nevertheless, the FRC supports the relocation of the auditor's opinion to the beginning of the auditor's report; with over three quarters of survey respondents also supporting this position. The auditor's opinion plays an important role in conveying the focus of the audit, and allows users to easily understand the key issues in the audited accounts and to identify highlighted areas in their subsequent consideration of the auditor's report.

ATTACHMENT A – AUSTRALIAN SHAREHOLDERS ASSOCIATION SURVEY ON PERCEPTIONS OF THE USEFULNESS OF AUDIT REPORTS, SEPTEMBER 2012