

Point of view

Our perspective on issues of concern

About this *Point of view*

Welcome to Ernst & Young's *Point of view* series. These documents express our view on current public policy and regulatory matters of importance to our stakeholders, our profession and the capital markets.

Auditor reporting: exploring options for change

Our point of view

Ernst & Young believes that in the wake of the financial crisis there is an opportunity to enhance auditor reporting to contribute to investor confidence. We therefore strongly support current efforts to explore options for improving the auditor reporting model and encourage the development of a standard auditor's report that would be used for all entities globally.

Context

The 2008 financial crisis triggered a reassessment of the role and responsibilities of all capital market participants. As part of this process, policy-makers are questioning whether auditor reporting could be improved to communicate more than a "pass/fail" opinion on the entity's financial statements. In addition, investors and other financial statement users are calling for more information about entities and their risks, as well as the audit process and auditor judgments and findings.

The International Auditing and Assurance Standards Board (IAASB)¹ and the US Public Company Accounting Oversight Board (PCAOB)² issued consultation documents in May and June 2011, respectively, to seek stakeholder input on options for change to the auditor reporting model.³ The PCAOB concept release focused on audits of US-listed public companies and explored four specific alternatives to the existing auditor reporting model. The IAASB consultation was more open-ended, seeking to determine whether key stakeholders hold common views about possible options to enhance the quality, relevance and value of auditor reporting. As a global standard-setter, the IAASB also asked stakeholders to consider the applicability of changes across jurisdictions and the potential applicability of new standards to both listed and non-listed entities. The comment period for each consultation has closed. We expect the PCAOB to propose standards in 2012 once it has assessed comments received. The IAASB also will undertake a project on improving auditor reporting in 2012, but that is expected to have a longer timeline. Due to the standard-setting process, we do not expect new, final standards until 2012 at the earliest. Ernst & Young has responded to each of these consultations, and the *Point of view* highlights the key points set forth in these letters.⁴

¹ IAASB, Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, May 2011.

² PCAOB, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements*, June 2011.

³ The debate is not limited to the IAASB and the PCAOB, as others such as the UK Financial Reporting Council and the European Commission have initiatives under way that include consideration of the form and substance of the auditor's report.

⁴ The Ernst & Young comment letter to the IAASB is available [here](#) and the letter for the PCAOB is available [here](#).

Key points

- ▶ **All potential changes to auditor reporting should be evaluated against a core set of principles that seek to keep investor's interests and audit quality at the forefront.**

In a letter to the PCAOB dated 9 June 2011, the US Center for Audit Quality outlined five overarching principles that should guide the development of any changes to the auditor's reporting model:

- ▶ Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.
- ▶ Any changes to the reporting model need to enhance, or at least maintain, audit quality.
- ▶ Any changes to the reporting model should narrow, or at least not expand, the expectations' gap.
- ▶ Any changes to the reporting model should add value and not create investor misunderstanding.
- ▶ Auditor reporting should focus on the objective rather than the subjective.

In our view, these principles support reporting enhancements for investors in a manner that is both meaningful and practical. Therefore, any potential changes to auditor reports should be derived from or consistent with these principles.

- ▶ **We support a single standard auditor's report that would be used for all entities globally, regardless of type or size of the entity.**

We believe that comparability is important for global investors and global markets; therefore, the auditor's report should be as consistent as possible across jurisdictions. The key elements of such a report should include:

- ▶ A clear expression of the auditor's opinion as to whether the financial statements, taken as a whole, are presented fairly in accordance with the applicable financial reporting framework
- ▶ Clarification of the responsibilities of management and the auditor

Although we recognize that certain differences in auditor reporting standards will continue to exist, unnecessary divergence in IAASB and PCAOB requirements (as well those of other jurisdiction-level standard-setters or regulators) could cause confusion and lead to inappropriate inferences about an entity's financial statements, audit quality and the nature of assurance provided.

- ▶ **For corporate reporting to be more meaningful to users, potential changes need to be considered holistically across the entire range of communications that are provided to users of financial information.**

The auditor's report is one element of the broader corporate reporting framework, which collectively provides appropriate and reliable information to users of the financial statements. We believe, therefore, that changes to auditor reporting should be made in the context of potential improvements to the total package of corporate financial reporting, including potentially expanded reporting by the audit committee, on which the auditors could report.

We encourage the IAASB, PCAOB and other standard-setters (e.g., the International Accounting Standards Board and the Financial Accounting Standards Board) and regulators to collaborate on initiatives to improve the nature and extent of corporate reporting as a whole, consulting with both preparers and users. Such a coordinated effort would help changes in auditor reporting more successfully address the information gap experienced by some users and mitigate an inappropriate expansion of the auditor's role.

Exploring the options for change

The IAASB and PCAOB consultations raised several potential options for changes to auditor reporting. We have evaluated the potential changes against the core principles described above and provided our views to each standard-setter accordingly, as follows:

- ▶ **We support an expanded use of emphasis of matter paragraphs in the standard auditor's report.**

Financial statement users have noted that, because the number and types of financial statement disclosures continue to grow, it is often difficult to identify those matters that are truly significant. Some users have noted that auditors can help them better focus their analyses. To address this demand, we support expanded use of emphasis of matter paragraphs for the purpose of highlighting and directing users to certain areas within the financial statements that:

- ▶ The auditor believes are significant to the users' understanding of the audited financial statements (e.g., an accounting policy or practice that has a significant effect on the entity's financial reporting, or a highly subjective accounting estimate)
- ▶ Received emphasis in the audit process (e.g., subject to discussion with the audit committee or those charged with governance, or required significant audit effort unique to the entity)

To achieve these objectives, the use of emphasis of matter paragraphs should be based on suitable, well-defined criteria for auditors to apply judgment in identifying matters to be emphasized. Importantly, we do not believe that such emphasis of matter paragraphs should include subjective auditor commentary about the entity or the audit.

▶ **We support adding clarifying language to the standard auditor’s report to enhance investors’ and other users’ understanding of the audit.**

Many investors and other users of financial statements have suggested that adding clarifying language to the standard auditor’s report could enhance users’ understanding of an audit. We agree and strongly support clarifying certain terminology in the standard auditor’s report, such as reasonable assurance, materiality and material misstatement, among others. We also support clarifying and expanding the descriptions of management’s and the auditor’s responsibilities in the standard auditor’s report. Among the clarifications that we have suggested are the following:

- ▶ Auditor’s responsibilities related to fraud
- ▶ Management’s responsibility for preparation of the financial statements and disclosures
- ▶ Auditor’s responsibility for financial statement disclosures
- ▶ Management’s and auditor’s responsibilities for other information in documents containing the audited financial statements
- ▶ Auditor independence

▶ **We do not support changes that would require subjective auditor commentary about the entity’s financial statements or the audit.**

We believe that any changes to the auditor reporting model requiring auditors to provide subjective views or commentary on financial reporting matters or the audit are not appropriate for general purpose auditor’s reports. Accordingly, we do not support the so-called “Auditor’s Discussion and Analysis” (AD&A) alternative discussed in the PCAOB consultation.

We believe the AD&A outlined by the PCAOB would present several significant challenges and have potentially adverse consequences. Principally, we do not agree that subjective views on financial reporting matters (including thoughts on “close calls”) or the audit can be appropriately conveyed and understood in the absence of an effective two-way dialogue. We also question whether an appropriate and practical framework could be developed and consistently followed for such disclosures to be meaningful for the reader, whether such disclosures would stifle communication between the auditor and the audit committee, and whether the additional focus on reporting as opposed to execution would hinder audit quality.

Points of debate

Should auditors increase their involvement with, or assurance on, all or certain portions of information beyond an entity's financial statements?

This option is worth exploring. Some investors have noted that they use sources of financial and other information beyond an entity's financial statements (e.g., earnings releases, key performance indicators, management discussions and analyses) and are looking for auditor involvement with, or assurance on, all or certain portions of this other information – particularly the most critical, subjective matters affecting a company's financial statements. The PCAOB has sought input on the possibility of auditor assurance on the Management Discussion & Analysis (MD&A) that is required under US Securities and Exchange Commission (SEC) reporting. Given investor emphasis on the most critical, subjective matters in a company's financial statements, we believe there may be value in separate auditor assurance on an issuer's disclosure of its critical accounting policies and estimates within MD&A, and we more generally support further exploration of the costs and benefits of enhancing the auditor's role in relation to information beyond the financial statements.

Would expanded reporting by management or audit committees address investors' needs for additional or better information?

Potentially. One option for providing additional information to users is through expanded reporting by management or those charged with governance (e.g., audit committees) in conjunction with expanded reporting by the independent auditor. For example, the UK Financial Reporting Council has issued a consultation document, *Effective Company Stewardship: Enhancing Corporate Reporting and the Audit*, which explores an enhanced corporate governance reporting model. Under this model, the audit committee would report publicly about its oversight responsibilities for the integrity of the external auditor on the completeness and reasonableness of the audit committee's report. The IAASB also explored this option in its consultation document.

We believe these options are worth pursuing, but they would require further analysis of the benefits and costs, including the extent of demand for such reporting and possible assurance. Among other things, these options would increase the scope of auditor's responsibilities and require the development of appropriate standards.

How can changes in auditor reporting be implemented consistently and in a timely manner across jurisdictions?

Certain changes in auditor reporting can be more readily implemented in the near term, while other options may require further research and collaboration before any standard-setting activities move forward. As stated previously, we believe that any changes to auditor reporting should be considered as part of efforts to improve corporate reporting generally. Therefore, we encourage the

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PCAOB and IAASB, as well as other policy-makers who are considering these issues, to coordinate efforts and undertake a multi-staged approach to enhancing auditor reporting in the context of initiatives to improve information provided to users of the financial statements.

However, we do not believe that a collaborative longer term effort should prevent some needed improvements to the auditor's reporting model in the near term. We believe that changes related to providing more clarifying language within the standard auditor's report and the expanded use of emphasis of matter paragraphs could be implemented in the relatively short term. For example, these changes could be implemented through changes in auditing standards alone and undertaken cost-effectively.

Other options, such as information beyond the audited financial statements, present challenges due to the need for collaboration among regulators and the need for further analysis of the demand and value of the options. We therefore see them as longer-term possibilities. We have encouraged standard-setters and regulators to explore change in these areas.

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