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SHAPING AUDITOR COMMUNICATION

Understanding Potential Implications, Embracing Challenges For Enhanced Value (Part 2)

BY
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In July 2013, the International Auditing and Assurance Standards Board (IAASB) released the exposure draft on standards pertaining to auditor reporting – Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs). Comment submissions on the exposure draft closed on 22 November 2013, and these proposed ISAs are expected to be effective in 2016.

The proposed enhancements include revisions to five existing ISAs, and the inclusion of one new standard which establishes requirements and guidance for the auditor's determination and communication of key audit matters. These enhancements aim to improve the auditor's report on audited financial statements by responding to the call of many for the auditor's report to be more informative and to provide more relevant information to users, giving more insights to the current binary report and shedding more light on critical entity-specific audit matters.

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Although these are undoubtedly important and positive changes to auditor reporting, such changes have a significant impact on all stakeholders, especially preparers of financial statements and the auditors themselves.

For auditors, the auditor's report is their final deliverable and the means of communicating the outcome or results of the audit. Any changes to its content and requirements would influence audit risk assessments and the corresponding audit processes and procedures. For management and those charged with governance (TCWG), any entity-specific disclosures within the key audit matters or going concern disclosures in the auditor's report would be intensively scrutinised because such entity-specific information would have a direct bearing on how the company is viewed by stakeholders.

To facilitate stakeholders' understanding of the new requirements and to encourage discussion among key stakeholders, the Institute of Singapore Chartered Accountants (ISCA) organised the forum, The Future Of Auditor Reporting – Shaping Communication and What It Means For You, in October 2013. The discussion highlighted the implications of these proposed changes, challenges that stakeholders should be cognisant of, as well as proposed solutions to these issues.

THE IMPACT OF GREATER DISCLOSURES AND IMPROVED COMMUNICATION

The enhancements to the auditor's report increase the amount of information disclosed therein. This is a positive development for corporate governance, and benefits investors whose investment decisions are influenced by the content of the auditor's report. However, auditors and management may not always agree on the nature and extent of the disclosures.

1 MANAGEMENT'S BUSINESS CONCERNS

Management may be reluctant for auditors to include certain key audit matters or certain descriptions of the key audit matters in the auditor's report. For example, the auditor may see the need to disclose certain information in order to explain the reasons why they consider the matter to be significant in the audit. Management, however, may view such additional information negatively and caution the auditors that such information may be price-sensitive.

In such situations, auditors have the discretion to exercise their professional judgement. The balance between management's demands and users' needs is a delicate one and the auditor has to ensure that this is achieved while complying with the requirements of the auditing and ethical standards.

Management and auditors may also disagree on the existence of material uncertainties which, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. Disclosures of material uncertainties in the auditor's going concern section of the auditor's report may potentially draw an adverse reaction from business partners, financial institutions or even the market at large. Auditors need to be sensitive to whether such material uncertainties disclosures would directly affect the company's business operations. Illustrating how such a thing could happen, Chia Nam Toon, Group Assistant Chief Executive Officer and Group Chief

Financial Officer, Ascendas, and one of the panellists at the ISCA Forum, said, "Financial institutions are likely to take it seriously, and may have no option and possibly withdraw their funding support. Hence, the very act of questioning the going concern of an enterprise could cause for it to come true," said Mr Chia.

Auditors, management and the audit committee will therefore need to hold numerous robust dialogues on significant risk areas of the company and significant auditing matters. Going concern discussions would include management's assessment of the company's future viability, future operating and financing plans. In particular, auditors need to ensure that the descriptions of key audit matters are succinct and clear and that an appropriate conclusion is provided on the company's financial viability and yet be cognisant of the negative unintended consequences that may arise.

DEFINING THE AMBIT OF KEY AUDIT MATTERS

The inclusion of key audit matters in the auditor's report is intended to increase the report's communicative value. Key audit matters have always been considered during the audit process, and the enhancements to the auditor's report simply call for them to be disclosed. However, the inclusion places considerable demands and responsibilities on the auditors, and has emerged as a potential point of contention between auditors, management and TCWG.

For a more productive dialogue on key audit matters, Shariq Barmaky, Deputy Chairman of the ISCA Auditing and Assurance Standards Committee and Partner at Deloitte & Touche LLP, recommended some pointers that could be incorporated into the audit process and procedures. Mr Barmaky was speaking at ISCA's auditor reporting forum.

- Select the most significant key audit matters from matters communicated with TCWG which are significant within the context of the company (that is, entity-specific). Greater conciseness will focus users' attention on what's most important and add value to the auditor's report.
- Avoid boilerplate descriptions as key audit matters are unique to the relevant financial year. Risks should be specifically identified in context.
- Explain why each key audit matter is significant to the audit, providing insights into the history of the matter if necessary.
- Quantify the contribution of the key audit matter where appropriate.
- Identify notes to financial statements where the key audit matter is explained.
- Be careful not to disclose detailed transaction terms as this may lead to "competitive disadvantage" for the company. However, consider adequacy of disclosure.
- Use simple and succinct language.
- Document the consideration as to why a matter communicated to TCWG has been included or excluded as a key audit matter, so as to have evidence of the work performed in the event of a review.

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2 AUDITORS' LIABILITY

Should a company develop real financial difficulty, the auditor's liability will more likely arise from insufficient disclosure rather than from over-disclosure. Investors will be less concerned with the accuracy of the auditor's opinion but will focus on whether any "omitted information" could have influenced their decisions. Kenneth Yap, Chief Executive, Accounting and Corporate Regulatory Authority (ACRA), observed that auditors are more likely to face this issue when called upon to stand by their opinion. "The difficulty will come not in defending what you say but what you don't say," said Mr Yap.

The perceived potential increase in auditor's liability may then "force" the auditor to set a lower threshold for material uncertainty disclosure in the financial statements. The auditor would adopt a more stringent criterion in assessing management's use of the going concern basis of accounting. The resulting material uncertainty disclosure may be self-fulfilling and trigger unwarranted implications, especially for companies with external borrowings, as discussed earlier.

3 RISING COSTS

Another more immediate challenge is cost. Audit fees will rise although the magnitude of increase will depend on the quality of the auditor's existing processes and procedures. The entity's management, directors and the audit committee would incur more time and resources prior to reaching an agreement with the auditors on the final form and content of the auditor's report. Directors' fees may even see a corresponding increase for the same reasons. The impact may be more apparent for companies which are less structured or have more accounting issues. In the long run, these increasing costs may make it more difficult for small and medium-sized companies to sustain a listing.

If companies are to accept these costs, they must be made aware of the value of audit and transparency. The regulator would have a role to play in supporting the view that audit is valuable to companies and stakeholders, and that the proposed changes would further enhance the value of audit. Public accounting firms may also need to reconsider their pricing strategies in order to stay financially viable themselves.

Most importantly, investors must be made aware that audit is beneficial to them. David Gerald, President and CEO of the Securities Investors Association (Singapore) (SIAS), expressed the view that investor demand will be key to compliance and that in the long term, audit costs will find an equilibrium. "If the audit process and disclosures help investors to make a better informed judgement, the big companies will not think twice about paying," said Mr Gerald.

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If the changes are properly implemented through robust and timely interaction and communication among the constituents of the financial reporting eco-system, the enhanced auditor's report will help raise the value as well as the pricing of audit over the next few years. As ACRA CE Mr Kenneth Yap put it, "This is a chance to reclaim ground for the profession by adding value to audit."

4 INCREASING COMPLEXITY

Financial statements have become increasingly complicated as more new and revised standards are issued, such that users, especially retail investors, may have difficulty understanding and interpreting the information contained therein. As there is already much complexity in today's financial statements, adding more information in the auditor's report may exacerbate this problem.

For the enhancements to the auditor's report to have actual value, stakeholders must be educated about the changes – not only investors but also management, directors and audit committee members. Mr Gerald said SIAS educates retail investors to understand financial statements and will continue doing so for the enhanced auditor's report as well. Similarly, organisations such as the Singapore Institute of Directors (SID) have a role to play in helping TCWG work with the auditors. Adrian Chan, First Vice-Chairman, SID, observed that directors and audit committee members are cognisant of the value in improving reporting, and are willing to accept training as a result. "TCWG will be eager to step forward and be educated and work with the various stakeholders." said Mr Chan.

USING THE ENHANCEMENTS TO ADD VALUE TO AUDIT

The audit profession should take the enhancements to the auditor's report as an opportunity to add value to audit, educate users and improve the quality of financial statements.

Other than informative value, the proposed changes allow information to be better presented in several ways. Firstly, clarity is added to the auditor's role, and there is greater transparency about the audit itself. This should help to correct any misperceptions of users about the role of the auditor and the audit process. For example, the going concern statement includes a disclaimer that the auditor's opinion is not a guarantee of the company's financial viability. The disclaimer may be insufficient protection against liability but the disclaimer as proposed by IAASB will better help define the auditor's responsibilities. Secondly, the enhanced auditor's report is organised in a format that can be more easily understood by users, including the prominent placement of important entity-specific information.

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The article, Shaping Auditors' Communication – IAASB's Exposure Draft Heralds a Sea Change in Auditor Reporting, which covered the key changes in IAASB's Exposure Draft, was published in the ***IS C**hartered **A**ccountant* journal, October 2013 issue.

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