

INNOVATION IN THE INTERNATIONAL STANDARDS FOR THE NEW INDEPENDENT AUDIT REPORT

Inovação nas normas internacionais do novo relatório do auditor independente

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Abstract: Historically, the independent audit profession faces a relevant challenge relating to the close of the users' expectation gap of its report on the financial statements of companies. Throughout the years, studies of this matter were made to identify main causes. As a result, a new standard on the independent auditors' report was internationally approved, which is applicable for financial statements of listed companies for the year ended on or after December 15, 2016 (for Brazilian listed entities, December 31st, as locally regulated). Among the main changes innovating the new independent audit report aiming to close the users' expectation gap are: the reorganization of the paragraphs of the auditor report to reflect the importance of the subjects; the confirmation by the auditor of his independence in relation to the company he is auditing; material uncertainty related to the entity's ability to continue operating (going concern concept) described in a specific section; the inclusion of a new paragraph for listed companies detailing key audit matters (KAM) found during the audit (disclosure is optional for other companies); new section on other information that accompany the financial statements (for example management report) and the results of the audit procedures applied to it; the evaluation of management of its responsibility relating to the capacity of the company to continue in operation (going concern concept); a more comprehensive description of auditor's responsibilities, including with respect to going concern. These changes compose the reply of the audit profession to close the user's expectation gap in relation to the new auditor report. The one relating to the inclusion of the new paragraph detailing key audit matters identified during the audit process is key to respond to the users of the audit report and give them additional information for his sensitivity market investment analysis and decision making process.

Key words: Audit, financial statements, independent auditor report, user's expectation gap

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Resumo: Historicamente, a profissão de auditoria independente enfrenta desafios relevantes relacionados com o atendimento da expectativa do usuário em relação ao relatório sobre as demonstrações financeiras das companhias. Ao longo dos anos, foram efetuados estudos relacionados com esse tema para identificar as causas principais. Como resultado, um novo padrão de relatório do auditor independente foi aprovado internacionalmente e é aplicável a demonstrações financeiras de companhias listadas relativas ao exercício findo em ou após 15 de dezembro de 2016 (no caso de companhias listadas brasileiras, 31 de dezembro de 2016, como localmente regulamentado). Entre as principais mudanças inovadoras adotadas para atender às expectativas do usuário, estão: a reorganização dos parágrafos do relatório do auditor buscando refletir a ordem de importância dos assuntos; a confirmação do auditor de sua independência em relação a companhia que está auditando; a inclusão de seção específica quanto à existência de incerteza relevante relacionada com a capacidade da companhia de continuar operando; a inclusão de um novo parágrafo para empresas listadas detalhando os principais assuntos de auditoria (PAA) encontrados durante a auditoria (opcional para outras companhias não listadas); uma nova seção sobre outras informações que acompanham as demonstrações financeiras (por exemplo, o relatório da administração) e os resultados dos procedimentos de auditoria aplicados; a avaliação dos executivos quanto à sua responsabilidade de a companhia continuar operando (going concern concept); e a descrição mais detalhada das responsabilidades do auditor, inclusive quanto ao tema da continuidade operacional da companhia. Essas mudanças compõem a resposta da profissão de auditoria para atender às expectativas do usuário em relação ao relatório do auditor. A inclusão de um novo parágrafo detalhando os assuntos-chaves identificados durante o processo de auditoria é relevante para responder ao usuário do relatório do auditor e dar informação adicional para análise e processo de decisão de investimentos.

Palavras-chave: Auditoria, demonstrações financeiras, relatório do auditor independente, expectativas do usuário

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INTRODUCTION

For many years, the value of the independent auditors' report to the society has been questioned. This questioning arises due to the fact that, despite the audit work of the independent auditors, the user of such report does not perceive it as a reliable source of information as many corporate scandals have arisen in the capital market.

In light of this matter, a new independent auditor's report was approved in July 2014 by the International Auditing and Assurance Standard Board (IAASB) and is applicable to the financial statements of companies with year ending on or after December 15, 2016 in the countries that adopt the International Standards on Auditing (ISA). For Brazilian listed companies this new report is applicable to financial statements ending on or after December 31st 2016, as locally regulated and in accordance with the Brazilian Federal Accounting Council, that approved the Brazilian Accounting Standard–NBC TA700, of June 17, 2016. Such regulation addresses the formation of an audit opinion and the issuance of the independent auditor's report on the financial statements of listed Brazilian companies.

Listed companies are those entities that have shares, quotas or other securities quoted or listed in a stock exchange, or traded according to the regulations of a recognized stock exchange or another equivalent body.

This new independent auditor's report includes changes broadly discussed internationally, aiming to improve the quality of audit engagements as well as to increase the amount of data provided by the independent auditor to the user of his report. This study aims to address what is known as "users' expectation gap" or "expectation-performance gap" and how the new auditor report is addressing this issue.

The importance of the independent auditor's work materializes to the market in general, especially to the stakeholders of such information, upon the issuance of his report.

As commented by professor Brenda Porter, Ciaran Ó hÓgargaith and Rachel Baskerville:

The criticism and loss of confidence in the audit function results from a mismatch or gap between society's expectations of auditors (whether reasonable or not) and what they perceive auditors to deliver. This gap may conveniently be termed as the audit expectation-performance gap (PORTER; BASKERVILLE, 2009, p.ii

These users, especially the investors who operate in the capital markets, expect that this report will be more informative and have been requesting a higher degree of details in the audit work performed by the independent auditor and, with regard to the more significant matters identified in their audit of the entity, how the report refers to them. Therefore, the new auditor report is no longer standardized; on the contrary, it will report important facts pertaining to each organization audited by the auditor.

Today the society is globalized, demanding, connected in real time, and, increasingly interested in transparent and more detailed information by those who participate in the corporate world and its capital market. One of these participants is the independent auditor, who audits the rendering of accounts of management, and issues his report on the information presented.

The areas with a higher risk of material misstatement in an audit engagement, due to their increased sensitivity, are usually subject to verification and in-depth analyses by the independent auditor. This task also includes extensive interaction with managers, in addition to discussions with members of audit committees, boards of directors, and all of those charged with governance in the organizations.

The demand for more information in the independent auditor's report arises, historically and all over the world, from critical events involving entities that operate in the capital market.

Clear examples are the cases involving major corporation scandals and whose businesses have global reach. Also, in particular, those operating in the financial market (the 2008 financial crisis still gives rise to concerns regarding the stability of the world economy).

The consequences of these occurrences, among others, motivated authorities to issue new regulations in every market, such as the Sarbanes-Oxley Act (2002), in the United States, with a global reach.

Sensitive events occur in all parts of the globe, such is the case of those events that currently affect the Brazilian economy and its political environment. Such facts have a tremendous impact on the credibility of the corporations, their corporate governance system and the accounting and financial information made available to their stakeholders and, consequently, on the reports issued on this information by the independent auditors.

Due to these circumstances, government authorities around the world, capital market regulators, academic entities and the auditors themselves, by operating in their institutional forums, conducted broad studies to analyze the reference standards that regulate the audit profession – especially, the independent auditor's report.

Intense studies and debates, that lasted around ten years, occurred on the need for a new independent auditor's report, approved in early 2015 by the International Auditing and Assurance Standards Board (IAASB) – an independent body that establishes international auditing standards for the auditors' profession. One of the main objectives of IAASB is to ensure quality and technical references for the performance of the audit work to assure that value will be added by the independent auditor's activity so as to respond to the users' expectation gap.

LITERATURE REVIEW

As regards the fulfillment of the users' expectation gap in relation to the auditors' report, this subject, as addressed in this document, has been discussed for a long period. The independent auditor's report debate lasts for over one hundred years, since the second half of the 19th century (CHANDLER; EDWARDS, 1996).

Such discussion is resumed whenever there are debacles of major corporations that operate in the capital markets, with an impact on the book value of their shares, significant losses in the equity of shareholders and other stakeholders. In these occasions, the market goes through credibility crises, involving stakeholders, especially the investors directly affected by the decrease in the value of their assets.

According to Théodore Limperg (1985, p.16,17): “The [audit] function is rooted in the confidence that society places in the effectiveness of the audit and in the opinion of the accountant.”

Researches and studies were carried out in several countries, such as the USA, Canada, the UK, Denmark, the Netherlands, Spain, Finland, South Africa, Singapore, China, New Zealand, and Australia. Among these studies, the Study of the Audit Expectation Gap (PORTER; GOWTHORPE, 2004) carried out in New Zealand, in 1989, and the Study of the Expectation-Performance Gap (Porter; hÓgartaigh; Baskerville, 2009), in New Zealand and in the United Kingdom, in 1999 (PORTER; GOWTHORPE, 2004), are of special significance. These several studies identified three main causes of audit expectation gaps, namely:

i) Unreasonable expectations – public expectations in relation to the work of auditors goes beyond what auditors can reasonably deliver.

ii) Deficiencies in professional standards – public has reasonable expectations in relation to the work of auditors that exceed the auditors' legal and professional responsibilities.

iii) Performance gap – The public perceives that auditors are not performing their required responsibilities to expected professional standards.

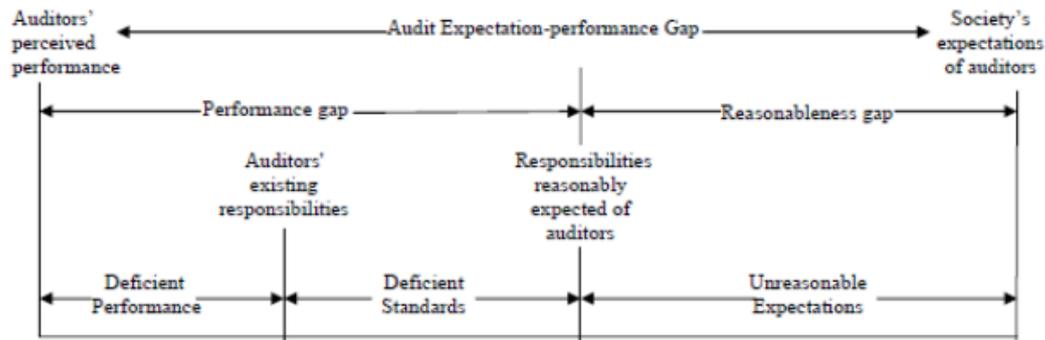


Figure 1: Structure of the audit expectation-performance gap
 Source: Porter (1993, p.50)

A comparison of the composition structure of the users’ expectation gap and its key aspects is shown in Table 1, below:

Study	Components of the audit expectation-performance gap		
	Performance gap		Reasonableness gap
	Deficient performance gap	Deficient standards gap	Unreasonable expectations of auditors
1989 (NZ)	11%	58%	31%
1999 (NZ)	6%	53%	41%
1999 (UK)	8%	42%	50%

Table 1: Proportion of the audit expectation-performance gap contributed by its components in 1989 in NZ, and in 1999 in NZ and the UK
 Source: Porter and Gowthorpe (2004)

Therefore, several studies, analyses and actions have been carried out to obtain a response to the users’ expectation gap.

In April 1988, the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards – Reports on Audited Financial Statements (SAS 58), which introduced the independent auditor’s report with additional information (long form).

The objective was to facilitate the understanding of the independent auditor’s report by the user, with the introduction of a paragraph to clarify management’s responsibilities in the preparation of the accounting and financial information. The text also describes briefly the audit process and the independent auditor’s responsibilities pursuant to professional standards for the performance of their work in the North American market.

According to the studies performed by Kelly and Mohrweis (1989), Hatherly, Innes and Brown (1991), and Zachry (1991), the implementation of SAS 58 increased the users’ understanding of the auditor’s report, by further detailing the accounting and financial information. However, the understanding of the long-form report became very complex and time consuming, which gave rise to questionings with regard to the expected cost-benefit relationship. Clearly, the expected result was not fully achieved.

The several studies carried out and the changes in the standards for the work of the independent auditor, as described, confirm the continuous search, of professionals and the society in general, for the answer to the users’ expectation gap.

METHODOLOGY

The nature of the matter under analysis is specific. Accordingly, aligned with the objectives proposed, the work performed is of a qualitative nature. It was based on the review of existing historical studies as well as on the more current initiatives, such as those being globally carried out in various forums, like universities, professional and regulatory bodies. Also, the extensive observation and interaction in professional meetings, congresses and workshops with respect of this matter was a key source of knowledge. Bibliography searches together with documental analyses were made, including audit norms and regulations in effect in different jurisdictions. In addition, new audit reports on financial statements issued in different jurisdictions were reviewed.

Information on this subject were i) the analyses and discussions that took place in various countries (particularly in Europe, where countries like UK and Netherlands anticipated the adoption of the new report); ii) the academic studies that were performed and the related technical discussions; iii) the professional institutional debates that occurred; and iv) the analyses and documents issued by regulators including those that arose from recommendations of public hearings on the matter of the users' expectation gap relating to the report of the independent auditor.

This kind of research, according to Minayo (2011), "answers events specifics" with respect to "a level of reality that can not or should not be quantified" (Oliveira, 2015 p.75) – Translated by the author.

ANALYSIS AND PROPOSAL FOR INNOVATION

In continuation of the studies of the users' expectation gap and the search for a solution, in 2004 IAASB started a project named Clarity aiming to continue to promote the analysis and review of the standards for the work of the independent auditor. One of the reasons for this project was to improve the quality of audits in general and, consequently, the fulfillment of users' expectations in relation to the auditor's report.

Issues related to the audit goals, the terminology used to mitigate ambiguous interpretations of the work performed and the independent auditor's responsibilities were reviewed. In summary, as a result of the efforts regarding project Clarity:

- i) 19 International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1 were modified to contemplate the new conventions and format.
- ii) 16 ISAs were reviewed and modified to include new requirements.
- iii) Issuance of a new standard, ISA 265, related to the communication of internal control deficiencies to those charged with governance.

The changes introduced by this project were approved to take effect internationally on December 15, 2009. Despite the advances obtained due to the initiatives associated to project Clarity, the users' expectation gap persisted with the growing skepticism of society regarding the value added by the independent auditor's report.

At the same time, due to the sophistication of the financial transactions contracted in the global market, the financial reports, which included these transactions, became increasingly longer and more complex, being understandable almost only to experts of the finance area.

IAASB, recognizing this context, sought to respond to the skepticism present in society as regards the value of the independent auditor’s work. Accordingly, in 2006, the entity established a specific study commission, which carried out several actions regarding this matter. The events below aim to show the schedule of important phases of this process that involved several organizations of society, such as academics, users of financial statements, different jurisdictions, those responsible for the preparation of the financial statements, auditors and regulators:

- a) Studies and academic researches carried out between 2006 and 2009 (some of which were sponsored by IAASB and the Auditing Standards Board (ASB)).
- b) Researches performed between 2009 and 2010, in different markets, and keeping up with the development of the subject with the regulators of the independent auditor profession.
- c) In May 2011, Consultation Paper – Enhancing the Value of Auditor Reporting: Exploring Options for Change, issued by IAASB.
- d) Start of the priority project by IAASB in December 2011, to analyze the responses obtained as a result of the Consultation Paper mentioned in the previous topic.
- e) Public consultations and round tables - Invitation to Comment, in July 2012 – Improving the Auditors’ Report.
- f) Exposure Draft, July 2013, Report on Audited Financial Statements: Proposed New and Revised ISAs, issued by IAASB.
- g) New ISAs (letter f above) were approved in July 2014.
- h) Publication of new ISAs in January 2015.

In 2012, IAASB conducted a series of international researches, including three round tables and 165 responses to the Invitation to Comment obtained from “Improving the Auditor’s Report. According to these researches, the independent auditor's opinion is an independent, safe and highly valued source for decision making, but the audit report could be more informative, with an actual opinionative function. (OLIVEIRA,2015, p.42) – Translated by the author.

Figure 2 shows an overview of the project of IAASB:

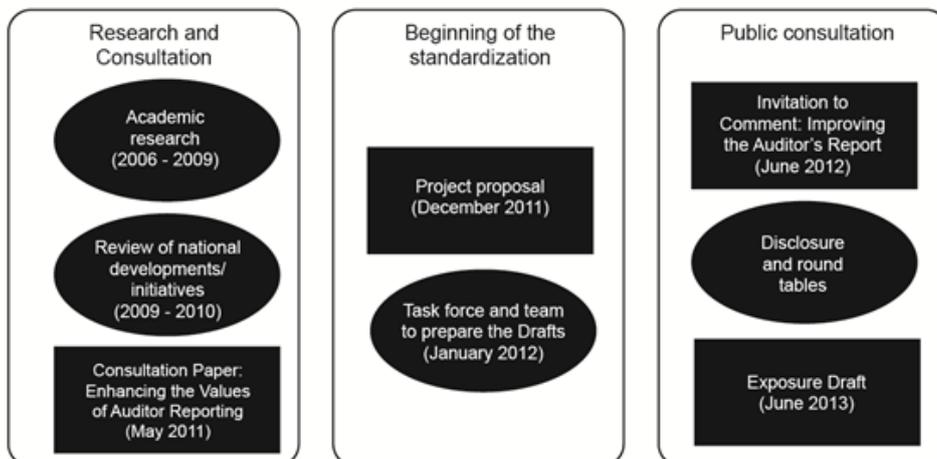


Figure 2. Overview of the IAASB report 2013 project
According to Oliveira (2015, apud IAASB,2013)

Based on the information above, researches, studies and debates were carried out in several forums, which involved entities and stakeholders that participated from different countries, including users with distinct views and goals. These debates were extensive and became more mature due to the repeated discussions and contributions received from participants. Accordingly, the results were analyzed, refined and consolidated so that the recommendations that arose were taken into consideration.

A significant landmark of this entire process was the Consultation Paper issued by IAASB, as previously mentioned – *Enhancing the Value of Auditor Reporting: Exploring Options for Change* – which received several comments of different organizations and distinct places in the world.

The comments received did not focus exclusively on the auditor's report. They also addressed matters related to the management of organizations, committees formed and the functions of corporate governance during the entire process of information gathering referring to the financial statements preparation process.

An important input received from stakeholders of this subject indicated that a relevant requirement of the users of financial statements or the companies, as prepared by management and as audited by the independent auditor, was for sufficiently and transparently communicate on the financial standing of the companies whose business they had the responsibility to conduct and to audit, respectively.

The IAASB project, with a duration of almost ten years, resulted in changes that are commented.

As a result of the aforementioned discussions, in 2013, IAASB submitted the *Reporting on Audited Financial Statements: Proposed New and Revised ISAs* to public consultation. This report model introduced important changes that resulted in the review of several standards, and which aimed to respond to the user's expectation gap.

One of the main changes was the new standard ISA 701, issued by the Brazilian Federal Accounting Council as a Brazilian Auditing Standard – NBC TA 701, of June 17, 2016, which addresses the *Communication of Key Audit Matters in the Independent Auditor's Report*. Therefore, this standard refers to the communication of key audit matters and the appropriate manner to describe them and aims to encompass the factors considered as most relevant during the performance of the audit, according to the judgment of the independent auditor.

This entire process and the related recommendations received resulted in new updates to the professional standards for the work of the independent auditor, which IAASB approved in July 2014 and published in January 2015. The Brazilian Federal Accounting Council introduced them as Brazilian Auditing Standards and published them in June 2016.

Figure 3 below shows a comparative summary between the independent auditor's report adopted previously and the new independent auditor's report approved, which will be internationally applied in audits relating to financial statements of listed entities beginning on or after December 15, 2016 (December 31st, 2016 in the case of Brazilian entities).

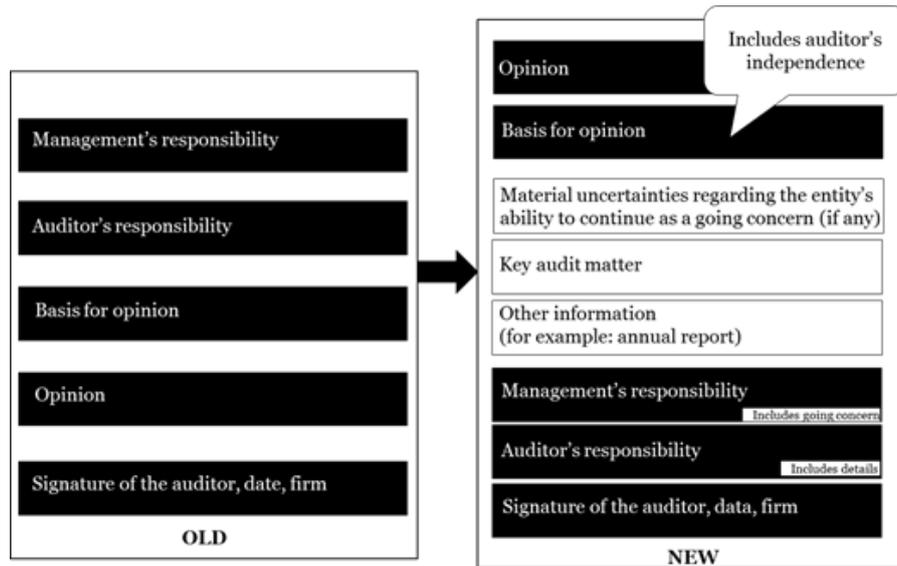


Figure 3 – Comparison of the old and the new auditor’s report

Source: Authors’ analysis

As shown in the figure above, the new Independent Auditor’s report:

a) Maintained, in essence, all the five paragraphs of the old report, which were, however, reorganized aiming to comply with the importance of the facts – the document now begins with the opinion of the independent auditor.

b) Included, in the aforementioned paragraphs, certain new information now explicitly presented. Examples are i) the independence confirmation, ii) the declaration of the CEO and CFO on the entity’s ability to continue to operate (ongoing basis), iii) the independent auditor conclusion on the accounting principles used by the entity regarding its operations on ongoing basis and his confirmation on this subject iv) the description of the audit plan and its main procedures.

c) Incorporated three new paragraphs arising from the recommendations received and originated from the studies carried out by IAASB, with the objective of improving the quality and amount of information communicated, presenting answers to the users’ expectation gap (fulfillment of the users’ expectations). The key audit matter (KAM) paragraphs are very important as they now inform the users of the audit opinion on the main areas of sensibility in the audit process, which previously were restricted to discussions with management.

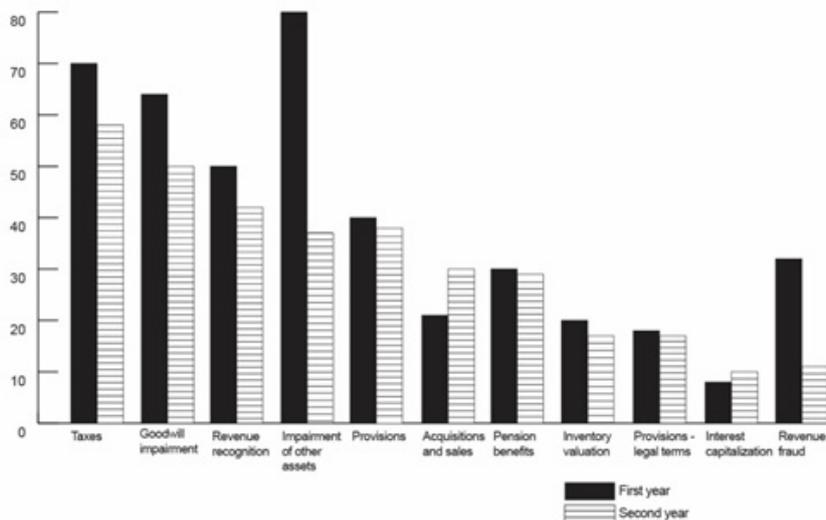
Thus, in a specific manner, the main innovative changes that will be included in the new independent auditor’s report can be summarized as follows:

Section	Description
Opinion	Content is maintained, and the text is transferred from the end to the beginning of the report.
Basis for opinion	Includes a statement regarding the auditor's independence.
Material uncertainty related to the entity's ability to continue as a going concern (if applicable)	Material uncertainty related to the entity's ability to continue as a going concern described in a separate section (close calls).
Key audit matters	New section required for the audit of <u>listed companies</u> . Disclose is optional for the other companies.
Other information	New section detailing the auditor's responsibility regarding other information that accompany the financial statements (for example: management report), and the result of the procedures applied to it.
Management's responsibility	Expanded to include an explanation of management’s responsibilities with respect to going concern.
Auditor's responsibility	More comprehensive description of auditor’s responsibilities, including with respect to going concern.

Table 2 – Structure of the new Auditor’s Report – an overview
Source: PwC

Considering the importance of this change, certain countries adopted pilots of the new report, thus testing in advance the results obtained with the new independent auditor report. These experiences provided mutual references, benefiting, as a whole, the final project approved by IAASB with regard to the new auditor’s report.

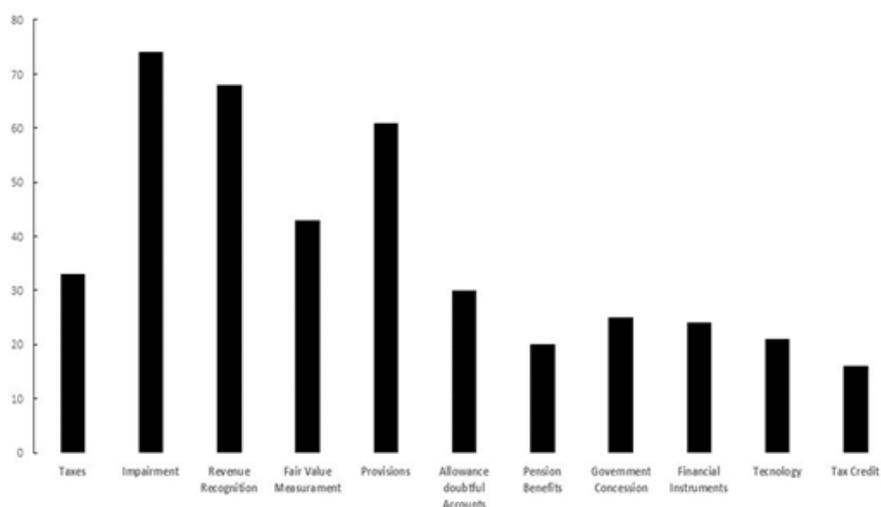
Graphic 1 below highlights the fact that the United Kingdom, as regards its processes, standards and business environment, anticipated the issuance of regulations that, despite being in line with the studies of IAASB, also considered certain specific characteristics of its market.



Graphic 1 - Subjects addressed in the new audit reports (%) – UK
Source: Financial Reporting Council (FRC) - United Kingdom

Graphic 2 below shows the main topics, up to March 13, 2017, that are being reported by listed Brazilian companies as well as some early adopters of the new auditor report model.

By comparing the UK experience with the Brazilian one, it is noted that there are similar subjects reported in both countries, such as: impairment, revenue recognition, provisions, pension benefits and taxation. Other topics disclosed in each country are more specific to certain segments of each market or characterizes a given circumstance of a business – for example, technological environment, acquisitions and sales and others. In general, it can be noted that in both countries there is a concentration on complex subjects involving judgement, estimation and projections, impairment and market valuation.



Graphic 2 - Subjects addressed in the new audit reports (%) – Brazil
 Source: Author’s analysis

CONCLUSION

With the establishment of the aforementioned broad process of studies and researches, which resulted in changes in certain existing audit standards, and the creation of new ones, important benefits are expected to arise from the new independent auditor’s report. These changes aimed at improving the quality of the audit, and fulfilling the users’ expectations regarding the independent auditor’s report. They are a response to the users’ expectation gap – with the objective of communicating more detailed information relating to the audit performed.

This new independent auditor’s report makes certain subjects more explicit, both with regard to the responsibilities of the management of the organizations and of the independent auditor. In turn, the stakeholders, with information on the key audit matters disclosed, may use them in their process of analysis and decision-making.

The document also discloses to the public in general issues significant to the user of this report, since the paragraph containing the key audit matter (KAM) was designed to present more detailed information on more sensitivity matters identified by the auditor in their audit process. In most cases, this information was restricted to internal discussions with the companies' corporate governance area. Accordingly, the new report provides benefits such as:

- ▶ Explanation of significant matters (KAM) to the public and main stakeholders, which were previously restricted to companies' governance areas (see Graphics 1 and 2 regarding the first experiences in the United Kingdom and Brazil).

- ▶ Explanation of the responsibilities of management and members of the corporate governance area, including with regard to going concern.

- ▶ Explanation, by the independent auditor, of the main auditing procedures applied (for example, analyses of risks, internal controls, communication with the governance area, analysis of accounting policies, including the preparation of the financial statements according to the going concern principles).

- ▶ Simultaneous reading of the management report by the independent auditor aiming to ensure the coherence and consistence of the information disclosed to the public

As it can be noted, there are expectations regarding how, in fact, the new auditor's report is contributing not only to the quality of the audit engagements, but also to improve the information expected by the public in general, thus responding to the user's expectation gap. As previously mentioned, the adoption of this new report is internationally still in its initial stage, thus presenting opportunity for studies that should be carried out by other researchers so that an updated view of the arising benefits and impacts of its adoption may be obtained.

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