AUDIT & ASSURANCE FACULTY

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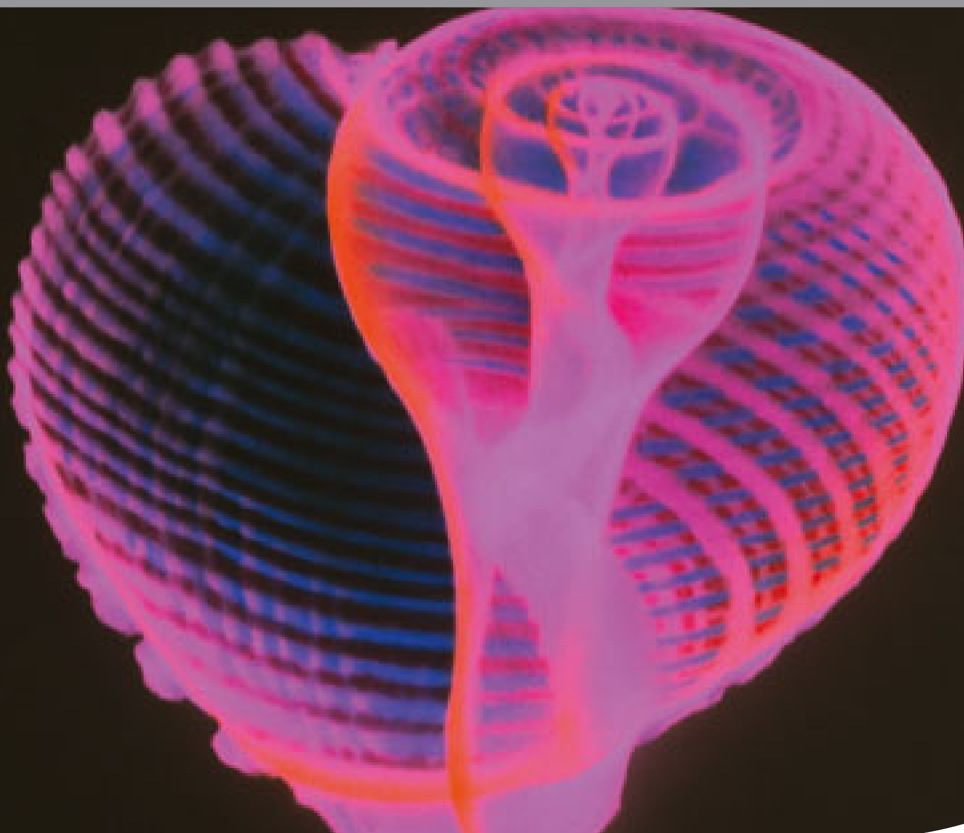
EVOLUTION

CHANGES IN FINANCIAL REPORTING AND AUDIT PRACTICE



The *Audit Quality Forum* brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

The completed programmes of *Supporting Shareholder Involvement* and *Fundamentals* of the *Audit Quality Forum* lead naturally to further work on the evolution of the audit. The forum's *Evolution* work programme covers the changing environment in which auditors work, the reporting relationship between auditors and the audit committee and how the differing interests of stakeholders and their expectations of audit can be reconciled.

Anyone interested in providing feedback on this paper should send their comments to henry.irving@icaew.com.

Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at **www.auditqualityforum.com** or or telephone +44 (0)20 7920 8493.

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Evolution
Changes in financial reporting and audit practice

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Executive summary

Introduction

Auditing is a dynamic discipline. Developments in financial reporting in recent years include significant changes in financial reporting standards, a greater use of fair values and the growth of narrative reporting. Developments in auditing standards and practices have been and are being driven, to some extent, by these changes. This has raised questions about the interaction between changes in financial reporting and changes in audit practice. The *Audit Quality Forum* established a working party to consider these questions. This report presents the results of its deliberations.

The working party was neither mandated nor minded to arrive at specific conclusions, but instead chose to articulate the challenges arising from adapting audit practice to changes in financial reporting. These have policy implications and point to areas where further research might be undertaken, they are primarily laid out in the section on adaptation challenges.

Changes in financial reporting

The nature of financial reporting

Financial statements contain many estimates even when they are prepared on the historical cost basis, because income and expenditure need to be allocated to reporting periods and information needs to be presented on a timely basis. Estimates and uncertainties have always been features of financial reporting which present challenges to preparers and auditors, but recent developments have increased these challenges.

Changes in financial reporting standards

Some changes in financial reporting standards have been driven by what has been learned from periodic crises and scandals. However, much stems from the increasingly complex transactions and businesses which financial reporting has to describe, particularly for the largest companies. Major changes in standards and standard-setting regimes have followed accounting scandals that seemed to indicate that standards had failed to keep up with the sophistication and complexity of the business transactions and economic models they purported to represent.

In the UK, standards have developed from relatively brief, high-level guidance to standards that are more rigorous, comprehensive and detailed. Judgement still needs to be applied in many areas of uncertainty and in preparing the specific disclosures that are required by, for example, financial reporting standards on financial instruments and liquidity.

Conceptual frameworks

Revisions to standard setters’ conceptual frameworks may well lead to future financial reporting standards that will increase the uncertainty attaching to financial statements and the range of possible outcomes they reflect. The move to treat ‘relevance’ as the primary qualitative characteristic of financial reporting information and to downplay ‘reliability’ may mean that preparers and auditors will have to deal with more uncertainty in the future. Those who strongly believe that this trend is damaging predict that global capital markets will come to regret the ‘loss’ of reliability as a primary qualitative characteristic further down the line but here, users of financial statements must be the arbiters. The role of auditors and the way they audit will play a part in the views of users, so users need to understand what audit can and cannot achieve.

Greater use of fair values

Standard setters increasingly require the use of current values as a basis of measurement in order to give information that is considered relevant to users of financial statements. The vast majority of assets and liabilities are still shown at amounts based on historical cost, but for certain types of entity, current or fair value is applied to a substantial part of the balance sheet. Auditors are, by default, obtaining assurance on future-oriented information and therefore, because users of accounts tend to be forward looking, assurance is more aligned with their interests. Greater disclosure of inputs and valuation methodologies has been driven by the need to compensate for the lack of familiarity of users of financial statements with many financial instruments, as well as an unwillingness to rely on 'black box' valuations carried out by experts, however well qualified. Concerns about how financial instruments, particularly untraded instruments, are valued have driven changes to disclosure requirements. Standard setters might usefully explore users' preferences for disclosures about the valuer or about the valuation.

Increased disclosures and narrative reporting

The rise in the complexity and volume of disclosures in annual reports is partly attributable to increases in the complexity of the financial affairs of companies, moves towards the 'audit society', an inability or unwillingness to exclude information on grounds of immateriality, and a widening in the perceived pool of stakeholders.

There is a growing interest in narrative reporting in many quarters. Sophisticated users increasingly attach considerable weight to non-financial information, but despite the high quality of much of what is disclosed, stakeholders are still not happy and expectations of narrative reporting rarely seem to be met.

Perhaps the most common problem with narrative reporting is the erroneous perception that it is unreliable because companies can report anything they choose. While companies wish to avoid the disclosure of commercially sensitive information, there are in practice numerous other factors that limit management discretion. Almost every stakeholder has slightly different information preferences and auditing the currently unaudited information that seems so helpful to some users is not straightforward.

Changes in audit practice

Judgement, uncertainty and the future

Developments in business, regulation, corporate governance and user expectations drive change in auditing standards and methodologies, as do changes to the content of financial statements. Even in a simple historical cost context, information about the future must be assessed during the audit of financial statements. Fair values, or at least current or market values, have been part of UK accounting since company audit began. What has recently changed is the widespread use of fair values both within and beyond the financial services sector, and the increasing complexity of financial instruments.

A raft of publications arising from the credit crunch that began in 2007 sets out the types of instrument whose fair value measurement or disclosure are affected by prevailing market conditions, the manner in which the relevant financial reporting standards should be applied and matters to be considered by auditors. The key message in many cases is that the normal rules do and should continue to apply and that professional judgement is required. However, as financial reporting standard setters consider the impact of recent events on fair value standards, one issue they perhaps need to consider is the relationship between uncertainty and auditability.

Sufficient, appropriate audit evidence

The question of what is sufficient, appropriate audit evidence has exercised auditors since audits began. It is also a major concern of auditing standard setters. Auditing standards state that what is enough is a matter of judgement but more evidence, obtained through additional time and cost, will not necessarily improve the quality of an auditor's conclusions. Changes to financial reporting standards have increased the extent to which auditors must use their professional judgement and there are new questions about whether auditors are obtaining sufficient, appropriate audit evidence. In 'mark to model' situations, for example, testing the appropriateness and the application of models replaces observation of market information as the primary evidence-gathering audit work.

How auditors adapt to change

How do auditors determine how much and what sort of evidence is enough in areas in which there is little or no established practice? Some things are objectively very much harder to audit than others, but auditors make them auditable. Academic work in this area reinforces what practitioners see as an inevitable part of the development of auditing practice: auditing is an art; the auditing profession takes responsibility for developing practice in new areas; and mistakes and disagreements along the way are unavoidable.

Auditing standards have developed in two ways to tackle uncertainty attaching to financial statements and the range of possible outcomes they reflect. Firstly, there is the increasing focus on audit risk, so that more work is done during audit planning to assess those areas that require most attention. Secondly, auditing standard setters have developed new auditing standards and provided more detailed guidance on specific aspects of financial reporting.

Adaptation challenges

Adaptation and liaison between standard setters

Auditors have had to deal with more financial reporting standards, as well as longer and more detailed standards. As a result of this, some dialogue and liaison between accounting and auditing standard setters is developing. Co-operation can help to ensure that accounting standard setters do not establish requirements that are, at least initially, incapable of being audited in the way the market expects. There is inevitably a lag between accounting and auditing standard setting, a further lag between the setting of standards and their becoming well established in practice, and there is also sometimes a lag between best practice in the market and auditing standards which have to catch up. Minimising the period of adaptation and the risk that this presents to the quality of financial reporting and auditing may involve enhanced liaison between accounting and auditing standard setters, and greater transparency about how auditors tackle new and emerging issues. The *Audit Quality Forum* strongly supports further liaison and co-operation between auditing and accounting standard setters.

Calls from users of financial statements for more information on how auditors tackle major issues of judgement in reports by oversight bodies on individual audit firms and academic research into audit practice are worth considering.

Cost-benefit issues and standard setters

There is little doubt that users consider the audit to be of considerable value. Research to establish what sort of benefit different categories of users get from the audit would be helpful, as would research into the reasons for changes in audit fees. The biggest problem with cost-benefit considerations in regulatory arenas is the measurement of benefits, and dialogue with the users who benefit from the audit should play a major role in decisions about the scope of audit. The costs and benefits of the incremental audit effort that results from new financial reporting requirements should be factored into decisions about changes to financial reporting standards and consideration should be given to changes to financial reporting standards that exclude certain requirements from the scope of the audit on the basis that the audit costs would exceed the benefits.

Varying levels of assurance

The fact that 'reasonable assurance' means different things in different situations prompts difficult questions about its meaning. Broadly speaking, a much higher level of assurance is seen as reasonable for cash than it is for illiquid derivatives, or even inventory. But this has always been the case. Nevertheless, one view is that what constitutes reasonable assurance, particularly on some balances and disclosures, has become so devalued that audit opinions are in danger of losing credibility. The *Audit Quality Forum* considered this issue and concluded that it continues to make sense to report an overall true and fair opinion on financial statements, even though the audit opinion is supported by audit work on different elements of the financial statements that yields varying degrees of assurance.

Gaps in audit coverage

Some users of audited financial statements are not aware of the precise scope of an audit and others disagree with it. Many are disappointed to learn that important information is not audited or subject to any direct work by auditors. Were additional information in the annual report to be the subject of further controls, questions arise as to the most relevant type of audit, assurance or other professional services and the need for management to appreciate the additional control needed to facilitate assurance in these areas. Further research into the costs and benefits of widening the scope of the audit would be helpful.

Auditor expertise

The boundary between what auditors should be able to do themselves, and what can be done by other experts reflects a debate about what constitutes the core competencies of auditors, but not all questions about how good auditors are at auditing complex valuations come down to issues of specialised experience and training. Research into the behavioural aspects of the audit of valuations presented to auditors by management would be helpful. Auditor expertise is increasingly stretched and consideration might be given to new specialist auditor qualifications used to restrict access to audits in certain sectors.

Complexity and the value of audit

Increased complexity is an inescapable feature of modern life. It applies as much to financial reporting as to other areas and raises a number of questions about how auditors can help preparers and users get the most out of complexities in financial reporting. As well as obliging companies to make financial statements clear, auditors might play a greater role in improving disclosures in the audited financial statements by having a specific responsibility to consider structure, clarity and overall understandability. Standard setters, preparers and auditors need to work together to extract the maximum value for
the different users of financial statements by making them easier to understand and more clearly signposted.

Introduction

Key points

Auditing is a dynamic discipline. Developments in financial reporting in recent years include significant changes in financial reporting standards, a greater use of fair values and the growth of narrative reporting. Developments in auditing standards and practices have been and are being driven, to some extent, by these changes. This has raised questions about the interaction between changes in financial reporting and changes in audit practice. The *Audit Quality Forum* established a working party to consider these questions. This report presents the results of its deliberations.

The working party was neither mandated nor minded to arrive at specific conclusions, but instead chose to articulate the challenges arising from adapting audit practice to changes in financial reporting; these have policy implications and point to areas where further research might be undertaken. These are primarily laid out in the section on adaptation challenges.

Background

Auditing is, like all professions, a dynamic discipline. Developments in financial reporting in recent years include, but are by no means limited to, significant changes in financial reporting standards, and an associated growth in the use of fair values and narrative reporting. Many changes in financial reporting have arisen from the need to provide users with appropriate information about increasingly complex businesses, transactions and instruments. Also, as part of the move towards international convergence in financial reporting standards, two of the world's leading standard setters are together looking at the conceptual frameworks underpinning standards. This may lead to further changes in the fundamentals of financial reporting, including shifting relative emphases to different attributes of financial information.

Auditing standards and practice have been and are driven to some extent by these changes, as well as by pressures for international convergence which mirror those in financial reporting. But the extent to which auditing practice has responded to shifts in financial reporting has not been thoroughly investigated, nor is it clear how much it can or should respond.

Developments in financial reporting and auditing might be expected to be closely intertwined, but the specific impacts of developments in financial reporting on auditing have rarely been considered, although there has been some academic research on the subject of 'auditability'. It has been suggested, however, that auditing should be more proactively considered in the context of what is deemed to be useful and reliable in corporate reports. This has raised questions about the interaction between changes in financial reporting and changes in audit practice which are worthy of exploration both in terms of past developments and potential future changes.

The *Audit Quality Forum* established a working party to consider these questions. The working party drew on a broad range of experienced preparers in a range of industries including banking and insurance, and users, regulators, auditors and academics. The membership of the working party is set out at the end of this report.

Objectives

Building on the *Fundamentals* programme of the *Audit Quality Forum*, this paper in the *Evolution* series considers the nature of audit evidence in the light of challenges such as:

- fair value accounting;
- the reporting of estimates and sensitivities;
- complex disclosures; and

- the interrelationship of financial statements with accompanying narrative information.

The working party also considered:

- the nature of the assurance auditors can obtain on different elements of financial statements, including note disclosures;
- the implications for audit practice and auditing standards;
- the sustainability of a single overall true and fair opinion given the different types of information covered by the audit; and
- the competencies necessary for an auditor to deal with new developments and provide a true and fair audit opinion.

Although the working party drew largely on its experience of UK practice, the fact that the UK has been at the forefront of moves to adopt International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISAs) means that this report will be of interest to a global audience.

Changes in financial reporting

Key points

The nature of financial reporting

Financial statements contain many estimates even when they are prepared on the historical cost basis, because income and expenditure need to be allocated to reporting periods and information needs to be presented on a timely basis. Estimates and uncertainties have always been features of financial reporting which present challenges to preparers and auditors, but recent developments have increased these challenges.

Changes in financial reporting standards

Some changes in financial reporting standards have been driven by what has been learned from periodic crises and scandals. However, much stems from the increasingly complex transactions and businesses which financial reporting has to describe, particularly for the largest companies. Major changes in standards and standard-setting regimes have followed accounting scandals that seemed to indicate that standards had failed to keep up with the sophistication and complexity of the business transactions and economic models they purported to represent.

In the UK, standards have developed from relatively brief, high-level guidance to standards that are more rigorous, comprehensive and detailed. Judgement still needs to be applied in many areas of uncertainty and in preparing the specific disclosures that are required by, for example, financial reporting standards on financial instruments and liquidity.

Conceptual frameworks

Revisions to standard setters' conceptual frameworks may well lead to future financial reporting standards that will increase the uncertainty attaching to financial statements and the range of possible outcomes they reflect. The move to treat 'relevance' as the primary qualitative characteristic of financial reporting information and to downplay 'reliability' may mean that preparers and auditors will have to deal with more uncertainty in the future. Those who strongly believe that this trend is damaging predict that global capital markets will come to regret the 'loss' of reliability as a primary qualitative characteristic further down the line but here, users of financial statements must be the arbiters. The role of auditors and the way they audit will play a part in the views of users, so users need to understand what audit can and cannot achieve.

Greater use of fair values

Standard setters increasingly require the use of current values as a basis of measurement in order to give information that is considered relevant to users of financial statements. The vast majority of assets and liabilities are still shown at amounts based on historical cost, but for certain types of entity, current or fair value is applied to a substantial part of the balance sheet. Auditors are by default obtaining assurance on future-oriented information and therefore, because users of accounts tend to be forward looking, assurance is more aligned with their interests. Greater disclosure of inputs and valuation methodologies has been driven by the need to compensate for the lack of familiarity of users of financial statements with many financial instruments, as well as an unwillingness to rely on 'black box' valuations carried out by experts, however well qualified. Concerns about how financial instruments, particularly untraded instruments, are valued have driven changes to disclosure requirements. Standard setters might usefully explore users' preferences for disclosures about the valuer or about the valuation.

Increased disclosures and narrative reporting

The rise in the complexity and volume of disclosures in annual reports is partly attributable to increases in the complexity of the financial affairs of companies, moves towards the 'audit society', an inability or unwillingness to exclude information on grounds of immateriality, and a widening in the perceived pool of stakeholders.

There is a growing interest in narrative reporting in many quarters. Sophisticated users increasingly attach considerable weight to non-financial information but despite the high quality of much of what is disclosed, stakeholders are still not happy and expectations of narrative reporting rarely seem to be met.

Perhaps the most common problem with narrative reporting is the erroneous perception that it is unreliable because companies can report anything they choose. While companies wish to avoid the disclosure of commercially sensitive information, there are in practice numerous other factors that limit management discretion. Almost every stakeholder has slightly different information preferences and auditing the currently unaudited information that seems so helpful to some users is not straightforward.

Companies capture data and process it to produce financial statements. The means by which such statements are produced is influenced by the needs of management who want to know that the information is properly prepared so that they can use it for their own decision making. Audit affects the process for preparing financial statements because supporting evidence needs to be provided to meet the auditor's requirements.

The nature of financial reporting

There are different levels of uncertainty attaching to financial statements and the range of possible outcomes they reflect, both overall, and in terms of individual numbers. Some inputs, such as the existence of a written contract, will be relatively certain, requiring little or no subjective judgement. Other information will require the exercise of a greater degree of judgement because a range of outcomes is possible both in terms of whether an item is recognised and how it is measured. The application of financial reporting standards does not eliminate such uncertainty nor reduce financial statement preparation to a mechanical process. Irrespective of whether information will be audited, management need to assure themselves that they have all the data they require to be satisfied that judgements have been properly made. When information is audited, management will build on what they do to satisfy their own need for assurance in determining how they will provide sufficient evidence to their auditors.

Financial statements contain many estimates even when they are prepared purely on the historical cost basis. This is because of the need for information to be presented on a timely basis. If preparers of information waited until all uncertainties had been resolved, then the information would have lost its value because of the passage of time. Thus, even for the transaction-driven, historical cost elements of financial reporting, the cut-off of a year, half-year or quarter end will necessarily mean that a view has to be taken of incomplete transactions and that estimates have to be made.

The following elements of financial statements involve estimates that are affected by differing degrees of uncertainty:

- Provisions and contingencies that are defined by reference to uncertainties. Estimates can be among the most problematic for companies and auditors. Some can be dealt with relatively easily on a portfolio basis if there is a strong historical pattern to serve as a point of reference. However, in the case of litigation or regulatory liabilities, uncertainty can exist as to fact (whether something actually happened), the future findings of a third party (such as a regulator or court) and the financial consequences of such findings (including damages and fines).

- Tangible and intangible assets which must be assessed for impairment on a regular basis. Judgement has to be applied to assess the cash flows, discount rates and other relevant inputs, as the assessment of recoverable amounts is often largely based on expectations about the future.

- Accruals and prepayments which are generally be straightforward to assess, but there may still be instances where some subjective judgement has to be applied, usually based on past history which might not be a reliable guide.

- Construction and other long-term contracts which need to be assessed when they are only part-completed at a reporting date and this can be complex. In many cases experts will be asked to provide information or to give an opinion. Experts' reports cover how complete the work is and the estimated cost to completion. While the latter may appear to be the harder question since it requires the expert to assess information about the future, the former may be just as troublesome.

Despite the fact that estimates and uncertainties are inherent features of financial reporting and always present challenges for preparers and auditors, recent developments seem to have increased these challenges. The main developments that we consider in the remainder of this section are:

- changes in financial reporting standards;

- conceptual frameworks;

- greater use of fair values; and

- increased disclosure and narrative reporting.

Changes in financial reporting standards

Financial reporting standards have developed substantially in recent years. Some of the changes have been driven by what has been learned from periodic crises and scandals but much of the change stems from the increasingly complex transactions and businesses which financial reporting has to describe, particularly for the largest companies.These two factors interact when major changes in standards and standard-setting regimes have followed accounting scandals that seem to indicate that standards have failed to keep up with the sophistication and complexity of the business transactions and economic models they purport to represent.

Standard setting in the UK was taken over in 1989 by the Accounting Standards Board (ASB) which proceeded to issue a raft of standards designed to tackle acknowledged problem areas including off balance sheet finance, capital instruments, mergers and acquisitions, goodwill and asset impairments and provisioning. While still being 'principles based', the style of the standards changed as they moved from being relatively brief, high-level guidance to standards that were more rigorous, comprehensive and detailed. The rise of the International Accounting Standards Board (IASB) and the widespread adoption of IFRS have continued this move to more rigorous standards.

Increasing detail in standards has not diminished the need to apply judgement to address uncertainty. Judgement needs to be applied in preparing the specific disclosures that are required by, for example, financial reporting standards on financial instruments and liquidity. Although standards are now more restrictive in the licence they give to account on the basis of management intentions, some standards still permit or require it, in classifying financial instruments as held-to-maturity, available-for-sale or held for trading, for example. In these situations there is obvious uncertainty about the future in terms of whether intentions will be acted on, and the standards are mined with penalties for management failing to carry out their stated intentions. For this type of uncertainty, preparers can only reflect current intentions, look at what actually happens once a management choice has been made, and ensure that the consequences of any changes in intention are properly reflected in the financial statements.

IAS 1 *Presentation of Financial Statements* requires disclosures about key accounting policies and judgements and sources of estimation uncertainty. In view of the market conditions at the time of writing, the UK Financial Reporting Review Panel has emphasised that companies should identify and disclose sources of uncertainty affecting estimates which carry a risk of causing a material adjustment to the carrying value of assets and liabilities.

Conceptual frameworks

Standard setters' conceptual frameworks can also be seen as increasing the likelihood that future financial reporting standards will increase the uncertainty attaching to financial statements. In the UK, the ASB produced its own conceptual framework document, the *Statement of Principles*, to underpin its financial reporting standards. This Statement, to some extent, reflected and further developed previous work done by US and international standard setters. Conceptual frameworks allow financial reporting standard setters' work to focus on what they believe the primary users of financial statements need to know and to move away from what may have been the original objectives of legal requirements for financial statements which encompass other objectives such as creditor protection.

In their conceptual frameworks, accounting standard setters have articulated an objective for financial reporting, which is to supply information to the providers of risk capital that will help them assess prospects for future cash flows: what return can they expect from their investment, and how variable and how secure is that return? This is perceived by some as a move away from the notion of financial statements as a reflection of the stewardship of the business that shows how directors or managers have discharged their responsibility to providers of risk capital in providing a return for the past period. However, the two purposes go hand in hand, insofar as providers of risk capital use financial statements for both purposes. The historical perspective of financial statements can be used as a feedback mechanism for the assessment of performance, including management performance, and the decision to continue to invest can be based on views about what will happen in the future based, in part, on past events.

Financial reporting standard setters are increasingly seen as placing greater emphasis on the relevance of financial reporting information to decision making by risk capital providers. Previously, financial reporting was seen as involving a trade-off between relevance and reliability, with reliability being a characteristic that reduced the risk to preparers and auditors of information turning out to be erroneous. However, the IASB has been working with the US Financial Accounting Standards Board (FASB) on a new conceptual framework which signals a change of emphasis. For some people, this means that financial statements will increasingly contain information that is not capable of being audited in the same way that other, more traditional elements of financial statements are. Such information relates more to the future than the past and is increasingly derived from expectations and current values than from historical transactions.

The new draft conceptual framework identifies the fundamental characteristics of relevance and faithful representation. These are supported by four 'enhancing qualitative characteristics', namely comparability, verifiability, timeliness and understandability. Verifiability is described as a quality of information that helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability is not the same as reliability since it simply implies that different knowledgeable and independent observers could arrive at a consensus on an item, although not necessarily complete agreement, whether it was a single amount or a range of possible amounts with related probabilities.

Verification can be direct, for example by counting cash or observing the quoted price of marketable securities. It is indirect where verification of an amount or other representation involves checking inputs and recalculating outputs using the same accounting convention or methodology. For example, the carrying amount of inventory can be verified by checking the inputs (quantities and costs) and recalculating the balance using the same cost flow assumption (such as average cost or first-in, first-out). The implication of this for some commentators is that any relevant information could be required by standards, regardless of reliability, provided that processes could be specified that allowed for consistent calculation of the numbers involved.

Verifiability appears to be directly relevant to auditing although no link is made to auditing or 'auditability' in the draft framework. Verifiability is first and foremost an important consideration for financial statement preparers operating in an uncertain environment where outcomes may be variable. Faithful representation is more likely to be linked to the enhancing qualitative characteristic of verifiability rather than reliability. The move to treat relevance as the primary qualitative characteristic of financial reporting information and

to downplay reliability may mean that preparers, auditors and users will have to deal with more uncertainty in the future and perhaps deal with it in different ways that depend more heavily on agreed processes of calculation. Those who strongly believe that this trend is damaging fear that global capital markets will come to regret the 'loss' of reliability as a primary qualitative characteristic further down the line; but here, users of financial statements must be the arbiters.

Greater use of fair values

As greater demands have been made on financial reporting standards to describe more complex transactions in terms of their impact on future cash flows, standard setters have increasingly required the use of current values as a basis of measurement in order to give information that is considered relevant to users of financial statements. A comprehensive review of the various current value bases of measurement, including fair value, is provided by the ICAEW report *Measurement in financial reporting*. The vast majority of assets and liabilities in the vast majority of financial statements are still shown at amounts based on historical cost. However, for certain types of entity, particularly financial institutions, current or fair value is applied to a substantial part of the balance sheet. Auditors are by default giving assurance on future-oriented information and therefore, because users of accounts tend to be forward looking, assurance is more aligned with their interests.

Fair value accounting can involve substantial challenges in determining hypothetical rather than actual market prices although despite its problems, the alternative can be more difficult. Some users of financial information have been reported as saying that they would like management to disclose their expectations of future cash flows where these would indicate a different value to the fair values recognised in the financial statements. Apart from the challenge of such an exercise, there is nothing to prevent companies from providing such information although some companies believe that they should not provide non-GAAP information that might appear to undermine GAAP information. The desire to see beyond fair values and not just to take them on trust can also be seen as symptomatic of a more general desire for ever more information in an uncertain environment.

Some of the earliest examples of current valuations were largely 'black box' exercises. This was certainly the case for property valuations. Although the name and qualification of the valuer might be disclosed, little was required on the inputs and assumptions the valuer had used. This approach started to change with the advent of new standards such as the UK standard on pensions, FRS 17 *Retirement Benefits*. Although an actuary is still required to carry out the valuation, disclosure is required of the major inputs and assumptions, allowing, in theory, users with sufficient expertise to adjust them as they wish, or carry out sensitivity analyses. Similarly, input and model information is required for financial instruments although until the introduction of IFRS 7 *Financial Instruments: Disclosures*, this was limited. Greater disclosure of inputs and valuation methodologies have been driven by the need to compensate for the lack of familiarity of users of financial statements with many of the financial instruments themselves, as well as an unwillingness to rely on 'black box' valuations carried out by experts, however well qualified. A group of companies might have many pension schemes and provide aggregated information about assumptions where inputs are common to all schemes and companies. But this is less often true of financial instruments which may lack common characteristics and have different valuation models and different inputs. In these cases aggregation exercises can be difficult to perform, audit and understand.

Experts have long had a role in financial reporting, providing valuations in areas such as property, pensions and financial instruments. Some financial reporting standards specify whether valuations should be performed by someone who is qualified in some way, whether the valuer can be internal or external to the company, and the publication of information on their independence and professional qualifications. The UK standard FRS 15 *Tangible Fixed Assets* is a case in point. It does not require disclosure of all the inputs to a valuation, the factors the valuer took into account and which model the valuer used, but merely sets the broad criteria which should be used for the valuation.

Other financial reporting standards, by contrast, contain no requirements as to the use of an expert at all. This is the case even though some of these valuations might be as material and specialised as a property valuation. Instead, more disclosures are required about inputs and valuation models used, so as to help those users who are able, to assess the valuation. Serious concerns have been expressed about how financial instruments, particularly untraded instruments, are valued and this concern has driven changes to disclosure requirements. Both the FASB and the IASB have introduced or proposed enhanced disclosure requirements for inputs into fair values, but not for who is carrying out the valuation.

It would be interesting to find out if the use, identity, independence and qualifications of experts are important to users of financial statements that contain current values, to assess whether disclosures about them should be made on a consistent basis. This might lessen calls for reams of additional disclosure on valuation inputs and sensitivities. Would users be prepared to accept a valuation 'black box' if they knew that the valuer was properly qualified and independent, or are users only prepared to rely on an expert valuation with no disclosure of inputs or models where the nature of the item means that market information is as visible and understandable as it often is in the property market? In the meantime, the trend towards fair values with related disclosures of inputs, models and sensitivities seems destined to lead to financial statements in which there is far greater apparent uncertainty and estimation. Audits of such financial statements will need to be controls based and information about valuation processes and controls may be the main focus of the audit.

Increased disclosures and narrative reporting

The increased complexity and volume of disclosures in annual reports can be attributed not only to the changes already described but also to:

- increases in the complexity of the financial affairs of companies, for example as a result of globalisation and technology;
- moves, in the UK and elsewhere, toward the 'audit society' described by Michael Power in which everything is expected to be transparent and everyone is expected to be accountable;
- an inability or unwillingness to contemplate the removal of disclosures or to exclude information on grounds of immateriality; and
- a widening in the perceived pool of stakeholders who make use of annual reports so that they have had to become all things to all men.

The broad areas into which narrative reporting has extended in recent years include governance issues, such as remuneration, and corporate social responsibility where disclosures are of interest to a very wide variety of stakeholders. A great deal of specialist industry-specific data is now also produced. There is a growing interest in narrative reporting in many quarters, including sophisticated users of financial statements who increasingly attach considerable weight to non-financial information. Given all this and the high quality of much of what is disclosed, it is perhaps puzzling that stakeholders are still not happy and that expectations of narrative reporting never quite seem to be met.

Perhaps the most common problem with narrative reporting is the erroneous perception that it is unreliable because companies can report anything they choose. While companies may wish to avoid the disclosure of commercially sensitive information, there are in fact numerous factors that limit management discretion. In the UK, for example, although there are legal safe harbours for narrative reporting, directors are only protected if they have acted properly and have not allowed misleading information to be published or material items to be omitted. Systems need to be set up to collect information, and the basis of presentation usually has to be disclosed to make information such as key performance indicators useful.

Almost every stakeholder has slightly different information preferences. For example, credit analysts want information on issues such as off balance sheet finance, debt location and covenants and outstanding bank facilities, whereas equity analysts focus on the future product pipeline, supply chain developments and management issues. Consequently, a frustrating aspect of increased complexity is that many stakeholders feel that despite all of the additional work that now goes into producing annual reports, much of the information they provide is not useful. Also, much of the information that is useful is seen as less useful than it might be because it is unaudited. The growth in complexity of reporting raises questions about both the scope and relevance of audit when it is limited to financial statements.

A natural development arising from increased complexity in financial reporting is a desire to find alternative means of communicating information to a wider range of users than the specialists who understand the 'hard numbers'. This is addressed in part by providing simplified financial statements to the generalist reader in the form of summary financial statements. There are, however, difficulties in the extraction of certain information from full audited financial statements: can such extracts be true and fair when they are incomplete and, if not true and fair, what standard should such extracts meet? Whether an audit opinion can be given on such extracts, either to a true and fair or to some other standard, is another issue about the scope and relevance of audit.

Changes in audit practice

Key points

Judgement, uncertainty and the future

Developments in business, regulation, corporate governance and user expectations drive change in auditing standards and methodologies, as do changes to the content of financial statements. Even in a simple historical cost context, information about the future must be assessed during the audit of financial statements. Fair values, or at least current or market values, have been part of UK accounting since company audit began. What has recently changed is the widespread use of fair values both within and beyond the financial services sector, and the increasing complexity of financial instruments.

A raft of publications arising from the credit crunch that began in 2007 set out the types of instrument whose fair value measurement or disclosure are affected by prevailing market conditions, the manner in which the relevant financial reporting standards should be applied and matters to be considered by auditors. The key message, in many cases, is that the normal rules do and should continue to apply and that professional judgement is required. However, as financial reporting standard setters consider the impact of recent events on fair value standards, one issue they perhaps need to consider is the relationship between uncertainty and auditability.

Sufficient, appropriate audit evidence

The question of what is sufficient, appropriate audit evidence has exercised auditors since audits began. It is also a major concern of auditing standard setters. Auditing standards state that what is enough is a matter of judgement but more evidence, obtained through additional time and cost, will not necessarily improve the quality of an auditor's conclusions. Changes to financial reporting standards have increased the extent to which auditors must use their professional judgement and there are new questions about whether auditors are obtaining sufficient, appropriate audit evidence. In 'mark to model' situations, for example, testing the appropriateness and the application of models replaces observation of market information as the primary evidence-gathering audit work.

How auditors adapt to change

How do auditors determine how much and what sort of evidence is enough in areas in which there is little or no established practice? Some things are objectively very much harder to audit than others, but auditors make them auditable. Academic work in this area reinforces what practitioners see as an inevitable part of the development of auditing practice: auditing is an art; the auditing profession takes responsibility for developing practice in new areas; and mistakes and disagreements along the way are unavoidable.

Auditing standards have developed in two ways to tackle uncertainty attaching to financial statements and the range of possible outcomes they reflect. Firstly, there is the increasing focus on audit risk, so that more work is done during audit planning to assess those areas that require most attention. Secondly, auditing standard setters have developed new auditing standards and provided more detailed guidance on specific aspects of financial reporting.

Changes in business, regulation, corporate governance and user expectations drive change in auditing standards and methodologies, as do changes to the content of financial statements. Auditing reacts to all of these drivers, as well as displaying its own internal dynamics. This section looks at the manner in which auditing adapts to changing financial reporting requirements.

Judgement, uncertainty and the future

Developments in business, regulation, corporate governance and user expectations drive change in auditing standards and methodologies, as do changes to the content of financial statements. Even in a simple and an entirely historical cost context, information about the future must be assessed during the preparation and audit of financial statements. This is because of the basic requirements for preparers to consider the recoverability of assets and the likelihood of potential liabilities resulting in future cash flows. It is also necessary to consider the future of the entire business when assessing whether financial statements should be prepared on the going concern basis. The problem of uncertainty, simply caused by trying to assess the future, can become acute here. Although the non-going concern basis of preparation is only applied to financial statements in extreme cases, substantial disclosures are required of the level and types of going concern uncertainty well before that point is reached.

Contrary to popular belief, fair values, or at least current or market values, have been part of UK accounting since company audit began. Their widespread use in the financial sector is not a recent phenomenon and indeed some companies in the past have voluntarily used current values for traded securities. A small number of companies provided for depreciation on a replacement cost basis even before the 1970s and property revaluations were increasingly common in that decade. This practice became a requirement for UK investment property companies in the 1980s. Defined benefit pension schemes have also long been accounted for using valuations based on highly subjective assumptions.

Where current values were used in financial statements in advance of being permitted by financial reporting standards or the law, companies used the ‘true and fair override’ and auditors had the choice of agreeing with the override and giving a clean audit opinion, perhaps with an emphasis of matter paragraph, or disagreeing and giving an ‘except for’, qualified audit opinion. However, most current values that were used were directly observable market values, which made them easily understood by users and relatively easy to audit. Auditing standards also addressed the use of the work of experts as audit evidence, including the terms under which auditors could rely on experts, whether they were engaged or employed by the company or the audit firm.

What has changed more recently is the widespread use of fair values both within and beyond the financial services sector at the same time as financial instruments have become more complex. In particular, the rapid increase in over-the-counter exotic instruments that are not traded on any exchange, has meant that more financial instruments are being ‘marked to model’ rather than ‘marked to market’. In the UK, the increasing importance of financial services to the economy has heightened the impact of these changes.

The increase in the use of fair values in financial reporting constitutes a challenge for auditors. Auditing standards specifically developed to deal with fair values such as ISA 545 *Auditing the Appropriateness of Fair Value Measurements and Disclosures* deal with ‘mark to model’ situations, by requiring testing of the appropriateness of the application of models, which replaces observation of market information as the primary evidence-gathering audit work. However, concerns among users about how financial instruments are valued become acute when they are unfamiliar with the subject of the valuation. The reaction of users to complexity is often to demand more information which, when it has been mandated by financial reporting standard setters, itself becomes subject to audit.

Management and auditors use a variety of tools and information and to a great extent, the past is adjusted for expected events and used to predict the future, whether in the context of going concern or fair values. In some cases, there is reliance on external information such as a history of judicial or regulatory precedents. However, in the case of asset impairments or going concern assessments, the main evidential material is preparers’ own assessment of expected future cash flows. In these circumstances, auditors can obtain some evidence as to expected future events which are scheduled to occur, such as the contractual expiration of debt facilities, but a great deal of evidence will simply consist of the expectations of people involved in the business concerned.

Auditors assess the reasonableness of preparers' expectations and this requires them to use professional judgement. Auditing standards accept the inherent limitations of audit evidence and permit auditors to obtain management representations. This is also one of the ways that auditing deals with certain aspects of financial reporting on management intentions. The ability to rely on representations is of course restricted to prevent auditors substituting it for other, better audit evidence. Management representations, while vital, are seen a something of a last resort.

It is in times of stress that the robustness of financial reporting and auditing are tested and when areas of weakness or concern are likely to be exposed, although care should be taken to ensure that 'lessons learned' stand the test of time; overreactions are not helpful. A raft of publications dealing with the effects of volatility in the world's capital markets on fair values has been issued by the profession, standard setters and regulators since the latter half of 2007. Broadly speaking, these documents set out, for the benefit of both preparers and auditors, some mix of information about:

- the types of instrument whose fair value measurement or disclosure is affected by prevailing market conditions, such as collateralised debt obligations, tranches of which include sub-prime mortgages;
- the manner in which the relevant financial reporting standards, IAS 39 *Financial Instruments: Recognition and Measurement* and the US standard FAS 157 *Fair Value Measurements*, should be applied; and
- matters to be considered by auditors.

Problems have arisen for auditors when faced with assertions by some companies (for understandable reasons), that the market is behaving irrationally and that it has effectively, if temporarily, mis-priced an asset, and that the quoted price is so low, stale, or reflective of so few transactions, that it is necessary to default to a model-based measurement reflecting the 'economic fundamentals' of the asset. In short, companies wanted to mark to model rather than mark to market.

The guidance produced in the US, the UK and internationally is aimed at helping auditors in the unusual and unprecedented circumstances of a severe financial crisis. Standards are not designed to cover all eventualities. Nevertheless a key message in much of the guidance is that the normal rules do and should continue to apply, and that professional judgement is required.

Questions have arisen as to whether the provisions of auditing standards on limitations of audit scope could be applicable in the present downturn. ISA (UK & Ireland) 700 *The Auditor's Report on Financial Statements* states that where limitations in the scope of the audit imposed by the entity might necessitate a disclaimer of opinion, the auditor should not take on the engagement. Other limitations in scope that would be reflected in the audit report include situations in which if, after the engagement has been taken on, evidence that would normally be available, is not, such as the loss of accounting records or the inability of the auditor to attend an inventory count. Auditors have had to apply these considerations to complex financial instruments where there is little in terms of established norms regarding evidence that would 'normally' be available and questions have arisen as to whether market volatility is of itself abnormal and an example of circumstances limiting the auditability of such instruments. Unlike unattended inventory counts, the situation is not clear-cut. A series of judgements must be made about illiquid markets and there may be substantially different levels of audit evidence available, ranging from only a little to a lot, covering a range of instruments.

Auditors have not been encouraged to issue emphases of matters or modified audit opinions as a matter of course on the valuation of some of these instruments simply because to do so would have caused a proliferation of such opinions. But some consider that it would be fairer to say that such items are inherently unauditable anyway, particularly in illiquid markets, meaning that the quality and extent of audit evidence available regarding such items is simply inadequate to support an unmodified audit opinion even in normal circumstances, whatever they might be.

Sufficient, appropriate audit evidence

The question of what is sufficient and appropriate audit evidence has exercised auditors and others since audits began. It is also a major concern of auditing standard setters. In the UK, the APB sets auditing standards which are based on the ISAs issued by the IAASB. ISA (UK & Ireland) 500 *Audit Evidence* states in paragraph 3 that: 'Audit evidence is all the evidence used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to address all information that may exist.'

Under the heading 'Sufficient appropriate audit evidence', paragraph 7 of ISA (UK & Ireland) 500 goes on to state that: 'Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The quantity of audit evidence is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated.'

How much evidence is enough? And has the answer to that question changed in response to the way that financial reporting has changed? Auditing standards, hardly surprisingly, state that what is enough is a matter of judgement. It depends on, among other things, the nature of the entity audited, the risks attaching to its financial statements, the level of assurance required, the availability of differing complementary types of audit evidence and the quality of audit evidence. The auditor's risk assessment will have a significant bearing on the determination of how much evidence is enough.

Some believe that, if money was no object and every auditor checked every transaction on every audit, there would be no misstatements, no fraud would be left uncovered and there would be no audit failures. However, a non-selective blanket approach to audit evidence is neither cost-effective nor logistically possible for anything other than the simplest of businesses. It makes sense to place some reliance on controls to obviate the need to look at the recording of individual transactions because of highly reliable automated transaction processing. At some point, audit evidence also has to be accepted at face value without looking for ever more proof and for this reason audits rarely involve the authentication of documentation. Moreover, some concept of materiality is required to determine what is a tolerable error, as is some notion of reasonable assurance that falls short of absolute assurance. In these respects, it is necessary to allow for the use of judgement in the audit process.

Even if there were no limits to the resources that could be devoted to audit, the need to apply judgement would mean that there could be no absolute guarantees. Audit evidence is generally persuasive rather than conclusive. A failure to appreciate this is one of the main sources of audit expectation gaps. Merely obtaining more audit evidence may not compensate for its limited value. Furthermore, where an audit failure does occur it is generally not because of a failure to perform an evidence-gathering procedure, but rather a failure to appreciate the significance of the result of a procedure. In such cases, like a doctor assessing the evidence provided by a patient's symptoms to come to a diagnosis, the auditor is likely to have had evidence of a problem but to have made an error of judgement as to its implications. More evidence, obtained through additional time and cost, will not necessarily improve the quality of an auditor's conclusions.

How auditors adapt to change

So how do auditors, in practice, determine how much and what sort of evidence is enough in areas in which there is little or no established practice? Questions arise as to whether current auditing standards give adequate guidance to auditors on how to apply their judgement in novel financial reporting areas, how auditing practice establishes itself, and how ultimately it becomes best practice and codified in auditing standards.

Academic work in this area, such as that of Michael Power in the article *Making things auditable*, indicates that the development of accepted practice arises in part through a 'constructivist' process. Auditors rationalise their subjective application of pre-existing processes to new areas, legitimise them within their own social structures and thereby harden them into apparently objectively justifiable procedures and methodologies. Some things are objectively very much harder to audit than others, but auditors make them auditable, thereby glossing over that fact. Some might take the view that this is merely an acceptance of reality and that it is no fault of auditors that, in rationalising what they have done to fit what they need to do, they implicitly promote the questionable idea that there are objectively verifiable criteria that can be used to validate accepted practice or the process that led to it. Nevertheless, this academic work reinforces what most practitioners would probably see as important facts about auditing, namely that:

- auditing is an art and not a science;
- the auditing profession takes on a heavy and risky responsibility for developing practice in new areas, including determining what is sufficient, while performing real audits; and
- mistakes and disagreements along the way are inevitable.

Auditing standards have developed in two ways to tackle different levels of uncertainty attaching to financial statements and the range of possible outcomes they reflect. Firstly, there is a much greater focus on audit risk, so that more work is done during audit planning to assess those areas that require most attention. Paragraphs 76-79 of ISA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* address business risk and state that looking at business risks is most likely to help auditors determine what needs to be audited. Secondly, auditing standard setters have developed auditing standards about specific financial reporting items that are subject to audit and provided more detailed guidance on certain aspects of financial reporting. Numerous auditing standards cover specific areas of financial reporting, although few give definitive guidance on exactly how much evidence is enough. Indeed it would be surprising if principles-based standards were precise on such matters. Examples of auditing standards which deal with specific areas are ISA 501 *Audit Evidence – Additional Considerations for Specific Item*; and ISA 545 *Auditing Fair Value Measurements and Disclosures*.

Adaptation challenges

Key points

Adaptation and liaison between standard setters

Auditors have had to deal with more financial reporting standards, as well as longer and more detailed standards. As a result of this, some dialogue and liaison between accounting and auditing standard setters is developing. Co-operation can help to ensure that accounting standard setters do not establish requirements that are, at least initially, incapable of being audited in the way the market expects. There is inevitably a lag between accounting and auditing standard setting, a further lag between the setting of standards and their becoming well established in practice, and there is also sometimes a lag between best practice in the market and auditing standards which have to catch up. Minimising the period of adaptation and the risk that this presents to the quality of financial reporting and auditing may involve enhanced liaison between accounting and auditing standard setters, and greater transparency about how auditors tackle new and emerging issues. The *Audit Quality Forum* strongly supports further liaison and co-operation between auditing and accounting standard setters.

Calls from users of financial statements for more information on how auditors tackle major issues of judgement in reports by oversight bodies on individual audit firms and academic research into audit practice are worth considering.

Cost-benefit issues and standard setters

There is little doubt that users consider the audit to be of considerable value. Research to establish what sort of benefit different categories of users get from the audit would be helpful, as would research into the reasons for changes in audit fees. The biggest problem with cost-benefit considerations in regulatory arenas is the measurement of benefits, and dialogue with the users who benefit from the audit should play a major role in decisions about the scope of audit. The costs and benefits of the incremental audit effort that results from new financial reporting requirements should be factored into decisions about changes to financial reporting standards and consideration should be given to changes to financial reporting standards that exclude certain requirements from the scope of the audit on the basis that the audit costs would exceed the benefits.

Varying levels of assurance

The fact that 'reasonable assurance' means different things in different situations prompts difficult questions about its meaning. Broadly speaking, a much higher level of assurance is seen as reasonable for cash than it is for illiquid derivatives, or even inventory. But this has always been the case. Nevertheless, one view is that what constitutes reasonable assurance, particularly on some balances and disclosures, has become so devalued that audit opinions are in danger of losing credibility. The *Audit Quality Forum* considered this issue and concluded that it continues to make sense to report an overall true and fair opinion on financial statements, even though the audit opinion is supported by audit work on different elements of the financial statements that yields varying degrees of assurance.

Gaps in audit coverage

Some users of audited financial statements are not aware of the precise scope of an audit and others disagree with it. Many are disappointed to learn that important information is not audited or subject to any direct work by auditors. Were additional information in the annual report to be the subject of further controls, questions arise as to the most relevant type of audit, assurance or other professional services and the need for management to appreciate the additional control needed to facilitate assurance in these areas. Further research into the costs and benefits of widening the scope of the audit would be helpful.

Auditor expertise

The boundary between what auditors should be able to do themselves, and what can be done by other experts reflects a debate about what constitutes the core competencies of auditors, but not all questions about how good auditors are at auditing complex valuations come down to issues of specialised experience and training. Research into the behavioural aspects of the audit of valuations presented to auditors by management would be helpful. Auditor expertise is increasingly stretched and consideration might be given to new specialist auditor qualifications used to restrict access to audits in certain sectors.

Complexity and the value of audit

Increased complexity is an inescapable feature of modern life. It applies as much to financial reporting as to other areas and raises a number of questions about how auditors can help preparers and users get the most out of complexities in financial reporting. As well as obliging companies to make financial statements clear, auditors might play a greater role in improving disclosures in the audited financial statements by having a specific responsibility to consider structure, clarity and overall understandability. Standard setters, preparers and auditors need to work together to extract the maximum value for the different users of financial statements by making them easier to understand and more clearly signposted.

The previous section presented the manner in which auditing adapts to changes in financial reporting, a description of audit issues raised by the credit crunch which are not yet fully resolved and concluded with how auditors adapt to change. This section sets out, in broader terms, potential challenges to the process of adaptation that might call for new thinking.

Adaptation and liaison between standard setters

Auditors have had to deal with a proliferation of financial reporting standards, as well as a new style of standard. For many years in the UK, auditors only needed to understand a few relatively brief standards and legislation relating to the preparation of accounts. Many areas of the financial statements had no particular standards governing them and, in the absence of such standards, auditors applied fundamental principles and through experience developed their own knowledge of and views on what was generally acceptable. Larger audit firms also developed internal views as to what was generally acceptable, dispersing that knowledge through the firm.

Now, there is a concern about the extent to which auditing has, in some sense, fallen behind financial reporting, for example where existing auditing techniques are not designed to cope with what are now important but highly subjective aspects of financial statements. Substantial revisions to the 'risk' ISAs by the IAASB have done a great deal to require auditors to focus on judgemental areas but there is inevitably a lag between accounting and auditing standard setting, a further lag between the setting of standards and their becoming well established in practice and, conversely, there is also sometimes a lag between best practice in the market and auditing standards which have to catch up.

The courts are the ultimate arbiters of truth and fairness of financial statements. They also opine on what constitutes reasonable skill and care on the part of auditors and have historically provided society's judgement on the appropriate extent and nature of audit evidence in new areas of accounting practice. But even here there is a delay between such judgements and the market forces which take time to establish accepted norms. In the light of this, the activities of audit regulators and standard setters can be seen as shortening lags in adaptation between financial reporting and auditing practice.

Experience suggests that, over time, financial reporting, auditing standards and practices in new areas do converge, but transitional periods are not acceptable to some who feel that the pace of change in financial reporting in recent years is preventing some areas from being effectively audited to an acceptable standard. It is also unclear how long it will take for a consensus to emerge on the audit of some of these newer areas and whether areas that might today be viewed as virtually unauditable will still be seen as such in 10 years' time.

The fact that it takes time for audit practice to adapt to new reporting requirements raises the following questions:

- Should there be greater liaison between accounting and auditing standard setters to consider auditability issues for new reporting requirements?
- Could the development of auditing practices in difficult new areas in financial reporting be accelerated by closer liaison among auditors?
- Should there be more transparency about how auditors are tackling new and emerging issues to accelerate improvements in practice and enhance confidence in audit?

The IAASB's Consultative Advisory Group has discussed the idea that there should be more liaison between auditing and accounting standard setters in relation to fair value; the timing of liaison could be earlier than it is at present. However, it is important that the development of financial reporting standards is not held back simply for the benefit of auditors. Indeed, it is for fear of this unintended consequence that there are some who believe that such liaison should not be encouraged.

Some dialogue and liaison between accounting and auditing standard setters has already developed but largely in the form of mutual observation. However, recent discussions have been held between the IASB, IAASB and others on:

- the auditability of, and approach to, fair value measurements, disclosures and estimates;
- the inherent limitations of an audit; and
- the need to balance the promotion of professional judgement with the need for auditor accountability in the context of the current regulatory framework.

Auditing remains vital to the overall process of building confidence in corporate reporting and enhanced co-operation might help to ensure that accounting standard setters do not establish requirements that are, at least initially, incapable of being audited in the way the market expects. If a requirement cannot be audited, that may also be a good indicator that it cannot be prepared reliably. Accounting standard setters can also better understand the cost-benefit implications of their proposed changes if they understand how the resulting information will be prepared and audited.

The *Audit Quality Forum* strongly supports further liaison and co-operation between auditing and accounting standard setters, while recognising that there are potential downsides. If past history suggests that auditing practice has reacted well over time to new financial reporting challenges, it would be a retrograde step for auditors and auditing standard setters, were they so inclined, to attempt to stifle proposed changes in financial reporting standards just because they create new auditing challenges.

Recent events show that the auditing profession and others can react quickly when the need arises. While it is unlikely that formal co-operation between audit firms would be feasible because of competition issues, liaison can be carried out in ways that do not raise such issues. For example, over the years, the APB has been helped by the firms to produce authoritative guidance in new, highly technical areas where it would have been difficult for a standard setter to have acted alone.

There would also be benefits in increased dialogue between auditing standard setters and users of financial statements. Users could gain further understanding about how auditing standards are set, the challenges of auditing in the existing and future financial reporting environment and the limitations of auditing. There is a need to ensure, however, that user demands for audit transparency do not risk substituting the audit for better disclosure by companies and undermining the effectiveness of the audit in reinforcing preparer responsibilities.

Calls from users of financial statements for more information on how auditors tackle major issues of judgement and debate are on the face of it, worth considering. For example, questions about how fair value disclosures are audited are of interest, particularly given the trend to require more disclosure of inputs, models and sensitivities. Caution needs to be exercised to ensure that well-intentioned ideas do not undermine the basic obligations of companies to disclose information and for auditors to express an opinion on that information and only to provide additional information when expressing a qualified opinion. Nevertheless, there are other opportunities for putting information in the public domain about how auditors are tackling emerging challenges in auditing, principally through:

- reports by public oversight bodies such as those published in December 2008 by the UK Financial Reporting Council's Audit Inspection Unit on individual audit firms; and

- academic research into audit practice, such as that currently being carried out by Vivien Beattie, Stella Fearnley and Tony Hines which follows up earlier research performed by Vivien Beattie, Richard Brandt and Stella Fearnley, the main output of which was *Behind closed doors: What company audit is really about*, published in 2001.

IAS 1 requires the disclosure of key accounting policies, judgements and sources of estimation uncertainty. Now that IFRS have been in force in the EU for several years, some in-depth research into how these elements of IAS 1 are being complied with would also be of interest, in terms of the types and number of items discussed and the extent of meaningful disclosure. This might help in policy formation for standard setters in areas such as whether the guidance in ISA 545 *Auditing Fair Value Measurements and Disclosures* should be extended to other elements of the financial statements in order to support the requirements of IFRS. Other questions that could be addressed include the adequacy of audit evidence in areas of uncertainty that require the application of judgement and what constitutes a reasonable sensitivity analysis. The greater the level of subjective decision making involved in the preparation of financial statements, the more auditors will be called upon to bring their judgement to bear on how preparers have applied their judgement.

Cost-benefit issues and standard setters

Governments and accounting and auditing standard setters do not find it easy to assess the effect of the changes they have made, but are under increasing pressure to do so. Auditability must be part of the cost-benefit consideration for financial reporting standard setters, which should include management's ability to verify their own numbers. The need to incorporate audit costs and benefits into the cost-benefit analysis of financial reporting standards is a further argument for increased liaison between accounting and auditing standard setters.

There is a natural tendency to assume that all requirements of new financial reporting standards that impact financial statements will be subject to audit whenever those financial statements are audited. However, even if it is accepted that auditing can adapt so that this assumption is realised and that all new requirements are ultimately auditable, it is still valid to ask how the costs and benefits of the incremental audit effort that results from new financial reporting requirements should be factored into decisions about changes to financial reporting standards, and to consider whether it would be possible to make a change to financial reporting standards but exclude certain requirements from the scope of the financial statement audit on the basis that the audit costs would exceed the benefits.

The biggest problem with cost-benefit considerations in almost all regulatory arenas is the measurement of benefits. It is clear that users need to drive the agenda and that dialogue with users should play a major role in regulatory decisions about the scope of audit. But for every additional dollar, pound or euro spent on an audit, how much more assurance will be provided, how much more likely is it that a fraud will be uncovered, and how much less likely is it that there will be an audit failure? That will depend to a large extent on where that additional dollar, pound or euro is best spent: should it be on checking transactions, testing controls, talking to management or performing confirmations? It seems possible that including additional disclosures within the scope of the audit may be counter-productive and reduce their benefit. Preparers may be inhibited from disclosing forward-looking or more judgemental information because they fear it may be perceived as difficult to audit, when users may find it more useful than the more routine audited information with which preparers feel more comfortable.

There would seem to be little doubt that users consider the audit to be of considerable value. However, research to establish what sort of benefit different categories of users do indeed get from the audit would be helpful even though in the UK auditors report to current shareholders rather than all users. A wider group of users of financial statements, beyond current shareholders, obtain benefit from the fact an audit is carried out, even if they cannot necessarily influence its scope and focus beyond the direct requirements of current shareholders.

In considering the benefits of auditing new financial reporting requirements, it is important to recognise what is likely to interest users about the implementation of those new requirements. Users are often concerned about whether the quality of auditing that might be applied to subsidiaries and associates internationally will be consistent and whether auditors can ensure there is not too wide a variation between judgements made on different audits. They are also interested in how auditors arrive at a view on particular issues, the audit processes used to establish the appropriateness of reported amounts, the areas in which the figures are unchallenged estimates and those which constitute major issues for detailed discussion and negotiation.

These matters should be important to standard setters and regulators, but there is little academic research on them and evidence is hard to come by directly, because of the need to use proxies even for costs, as well as benefits. Additional costs can be difficult to determine directly. Has the audit fee gone up because the business has expanded its operations, because the audit firm has negotiated a better fee, or because it was genuinely considered that more money was needed to obtain a high quality audit?

As judgement has come to play an ever greater role in the preparation of financial statements as a result of the use of fair values, for example, another dimension has been added to the debate; users of audited financial statements have believed that standard audit processes could be applied to ensure that the 'wriggle room' for preparers is minimised and to prevent a wide variety of valuations for essentially similar items. There is also an assumption that the outcome will fit in with the existing market for audit in which the cost of audit and the price the market will bear are seen to be justified by audit benefits in terms of the level of assurance that can be obtained, the time frame within which it can be provided and the level of audit failure the market will bear. But the trade-off between the costs and benefits of audit has yet to be fully explored.

The cost-benefit balance in setting auditing standards is difficult to achieve, maintain and measure. There is a significant risk that adding costs to the audit in the form of auditing standards and regulation may not yield commensurate benefits. Proving this one way or the other is not easy and further work in this area would be timely.

The IASB and the European Financial Reporting Advisory Group have undertaken to carry out cost-benefit analyses on financial reporting standards. As discussed in the *Audit Quality Forum* publication *Making global standards local*, a problem may be that, while standards are set internationally, cost-benefit considerations can only be assessed, and are only relevant, at a local level. However, cost-benefit analyses are difficult to prepare even on a national basis although some standard setters have made attempts to do so, including the APB in its consultation on the adoption of clarified ISAs in the UK.

Varying levels of assurance

The mere fact that reasonable assurance means different things in different situations raises questions about whether reasonable assurance, particularly on some balances and disclosures, has become so devalued that audit opinions are in danger of losing credibility and whether it makes sense any more to report an overall true and fair opinion on financial statements when the audit opinion is supported by audit work on different elements of the financial statements, that yields widely varying degrees of assurance.

In 2002, the IAASB published an academic study entitled *The Determination and Communication of Levels of Assurance other than High*. This showed clearly that 'reasonable assurance', which is what auditors aim to obtain overall on financial statements, encompasses a very wide range of assurance on individual account areas depending on the 'hardness' of the subject matter and the level of auditor work effort. This issue is of considerable concern to some and merits further debate.

Those who describe certain items as unauditable are effectively taking this argument further and stating that some items are outside all reasonable parameters in the continuum of what can be described as 'reasonable assurance'. The auditability of fair values is discussed in some detail in the ICAEW report *Measurement in Financial Reporting* which calls for more research on the auditability of information prepared on different measurement bases. Some people feel particularly strongly on the issue of auditability and argue that the relatively low level of assurance that is being obtained in some areas, such as non-market-based fair values, is now so far removed from the high level of assurance that is provided in other audit areas, that the overall audit opinion can no longer be regarded as cohesive.

Should there be some differentiation in the levels of assurance provided on different elements of the financial statements? Users of financial statements have long known that there is no uniform degree of assurance on all such items. The *Audit Quality Forum* considers that it continues to make sense to report an overall true and fair opinion on financial statements, even though the audit opinion is supported by audit work on different elements of the financial statements that yields varying degrees of assurance; this has always been the case and may rather be an educational issue for users of the audit report.

Gaps in audit coverage

Although anecdotal evidence may need to be confirmed through more formal research, it is clear that some users of audited financial statements are not aware of the precise scope of an audit and others disagree with it. A common complaint is that auditors audit some information, including many statutory disclosures, that is not particularly helpful to readers. Conversely, readers have no assurance as to the quality of what they believe is very important information about the performance of a company because it is outside the audited financial statements, located in other material which the auditors only read for consistency with the financial statements. For example, in the UK, many would be disappointed to learn that important information, for example key performance indicators in narrative reports, is not audited or subject to any direct work by auditors. The status and quality of various types of information needs to be made clear. As information provision expands, questions arise not only about the role auditors can and should play in obtaining assurance over financial information within the annual report but also outside the financial statements, and the type of audit, assurance or other professional services that would be most relevant.

From a technical auditing standpoint, the relationship between the audited financial statements and all the other information accompanying them, including any narrative report is determined by auditing standards and company law: ISA (UK & Ireland) 720 on other information and section 496 of the Companies Act 2006. The legislation requires that the auditor state in his report whether the information in the directors' report is consistent with the financial statements, including anything that is cross-referenced. The auditing standard goes further and requires that auditors read the 'other information' to identify material inconsistencies with the audited financial statements or material misstatements of fact.

This 'other information' includes the directors' report, corporate governance statements, chairman's statements, operating and financial reviews (OFRs) or business reviews, and non-statutory financial information included in the annual report. The area is clearly one of increasing importance to preparers and auditors as new information is included in annual reports and cross-references to such information become increasingly common. However, the responsibilities of auditors for other information are regarded by some as ineffective because the matters reviewed bear no relationship to the financial statements audited and have little need to be consistent with them. There is a risk that an unwarranted high level of assurance is being presumed by users which is inappropriate. A review of these requirements may prevent the growth of further expectation gaps.

Current requirements relating to other information published with financial statements might need to be reconsidered. In particular, there are elements of this information on which statutory auditors might obtain a higher level of assurance, and where assurance might be provided by persons other than statutory auditors if the subject matter is beyond the normal competency of the statutory auditor.

Although users may want more assurance over at least some parts of narrative reports, there are potential drawbacks. The primary purpose of narrative reporting in the form of an OFR or business review is for management to explain the company's performance and prospects to shareholders. If auditors are asked to provide more assurance on such reports, there is always a risk of a loss of meaningful communication and the development of boilerplate. Auditors can make the situation worse by 'getting in the way' of the communication process. The provision of audit-level reasonable assurance on non-financial information is particularly difficult and management may not realise how much additional control would be needed to facilitate assurance in these areas.

The *Audit Quality Forum* paper in the *Evolution* series *Stakeholder expectations of audit* also highlights some additional risks that need to be guarded against. It notes that it is relatively easy to respond to user dissatisfaction by making proposals for extending the statutory audit without necessarily thinking of the consequences. These would include the risk of tainting the purpose of the statutory audit which in the UK and elsewhere is firmly rooted in the idea of auditors as independent agents of the body of shareholders.

Problems may also arise in relation to some information that is currently within the audited financial statements where there is an explicit focus on management's view. Would users be able to accept more of an unaudited, unreviewed and even unread 'management view' of, say, segmental reporting? A seemingly innocent 'read' requirement can represent a very substantial amount of work in a high profile and risky area for auditors, especially as they are required to take appropriate action if something appears 'not quite right'.

It is also appropriate to consider whether other types of unaudited report now commonly provided to shareholders or other stakeholders are susceptible to audit or some other form of assurance, either by the statutory auditor, by other experts or by both. Corporate social responsibility reports are a case in point; some have assurance provided by statutory auditors, others by consultants and, in some cases, both. Some stakeholders are very uncomfortable with the idea that assurance can be provided by anyone other than the statutory auditor, whereas others think that statutory auditors have no locus with regard to reporting outside financial statements.

Auditor expertise

The impact of changes in financial reporting on audit practice highlight auditor expertise issues including: whether the proliferation of new financial reporting standards and the knock-on effects on auditing standards stifles the development of auditor judgement; the asset measurement skills needed to be an effective auditor; and the need for specialist auditor qualifications and whether they should be used to restrict access to audits in certain sectors.

The elements of professional examinations relating to financial reporting for accountants and auditors have grown in scale and importance, but continuing professional development (CPD) is also crucial because the pace of change of standards has rapidly increased. This represents a risk for auditors. The larger audit firms have always had technical departments, and the importance of these has increased as a result of changes to financial reporting and financial reporting standards. They represent a considerable investment.

More auditing standards also mean more for auditors to learn during their initial training and subsequently through CPD. But there are also concerns that auditors are being trained to tick the boxes required by auditing standards rather than developing the professional judgement vital to audit quality. This is a continuing tension in the development of auditing standards, particularly in the context of regulatory scrutiny where the failure to carry out a specific procedure required in an auditing standard, or even one that is just suggested, may be interpreted as poor auditing.

Developments in what is audited require auditors to develop new skills to respond to the challenges of a changing environment, such as the skills required to audit the modelling techniques used in fair value measurements and the probability theory underlying certain accounting estimates. Large audit firms have developed their own in-house teams of technical experts in various fields and now employ actuaries, surveyors and the like. While audit firms frequently employ experts with these skills, auditors themselves need a good grounding in areas of specialisation if they are to make effective use of experts.

The boundary between what auditors should be able to do themselves, and what can (and perhaps should) be done by other experts, was a recurring theme of working party discussions. The work of actuaries and other valuation specialists has been used as audit evidence for many years by auditors and auditing standards specify how auditors should use experts, but there is a debate over what constitutes the core competencies of auditors.

Although auditors' ethical codes prevent them from accepting engagements that they are not competent to carry out, all auditors – whether they audit banks or one-man service companies – have the same generalist auditor qualification. The Professional Oversight Board and the professional bodies may need to consider whether this is a sustainable model or whether, in addition, there should be specialist auditor qualifications for certain audits, such as audits of banks, insurance companies and other financial institutions. This could involve receiving authorisation from a regulator on the basis of experience and further study, assessment and monitoring. Certain types of audit could be closed to those without the relevant specialist qualification. However, initial indications suggest that there is little appetite for this at present.

Changes in what is audited mean that post-qualification experience and training are more important now than ever before, and the move towards specialisation, even among smaller general practitioners, is one aspect of this. Regulators, professional bodies and audit firms have already started to consider the consequences. Yet it would be a mistake to think that all questions about how good auditors are at auditing complex valuations, for example, come down solely to issues of specialised experience and training. While individual cases of perceived audit failure involving misstated valuations might be attributable in part to a lack of specialisation, more general questions need to be asked about the extent to which and why auditors may be susceptible to accept valuations which are (and not always just with the benefit of hindsight) inappropriate. If it is easier for management to misuse softer valuation data for earnings management and more difficult for auditors to confront management on judgemental valuations, then the relevant behavioural issues need to be addressed in auditors' professional development. There may also be a need to counter perceptions that the penalties for acquiescence in inappropriate valuations are likely to be lighter because of the difficulties of demonstrating after the event that a judgement was not appropriate at the time that it was made.

Complexity and the value of audit

Generally, the effect of changes in financial reporting standards in recent years has been to increase the length of financial statements, which has in turn caused some to complain about not being able to see the wood for the trees. The measurement bases on which financial statements are prepared and associated disclosures are increasingly complex and subjective. In areas of less understanding, it is also likely that detailed, process-based auditing and financial reporting standards will develop rather than output-oriented standards. These issues are discussed in some detail in the *Audit Quality Forum Fundamentals* publication *Principles-based auditing standards*.

Increased complexity is an inescapable feature of modern life. It is arguably the most significant change in financial reporting in recent years and consideration could be given to permitting or obliging auditors reporting on the true and fair view to try and make financial statements easier to understand. As well as obliging companies to make financial statements clear, auditors might play a greater role in improving disclosures in the audited financial statements by having a specific responsibility to consider structure, clarity and overall understandability. Standard setters, preparers and auditors need to work together to extract the maximum value for the different users of financial statements by making them easier to understand and more clearly signposted. This is an issue the FRC is looking at in its project on reducing complexity.

While a great number of smaller UK shareholders now receive summary financial statements by default, the problems of complexity and volume, which are distinct but overlap, are a very real issue for auditors. The problems of complexity are being examined by academics in a number of different contexts but there is little detailed work on the effects of complexity in accounting and how this affects auditing. The London School of Economics Centre for the Analysis of Risk and Regulation has performed some interesting work in the area of complexity in regulation generally. It seems, however, that reducing complexity is often more difficult than it should be. There are objections from those for whom complex regulation actually benefits and also from those for whom simplification is intended to benefit. Analysts rarely reject the possibility of more information and therefore it is not surprising that disclosures are hardly ever abandoned. This calls into question the basis of some attempts to reduce complexity. In the past, complexity may have been perceived primarily as a problem for users of financial statements who were seen as needing education in financial reporting matters. Now that complexity is an issue for everyone, it seems more important that users play a more active role in standard setting.

Arguably, the need to be clear and, where possible, concise, is an element of the true and fair view on which both preparers and auditors have to make a judgement. Perhaps it should be made more explicit, so that part of the job of management is to ensure that users of financial statements can see the wood for the trees. The auditor's 'standback', required by the true and fair view and overtly stated in UK law, could also require auditors to propose changes to disclosures that will make annual reports more readable and more comprehensible. Anecdotal evidence suggests that auditors do put pressure on companies to make links between related disclosures that might not be strictly required by financial reporting standards or legislation. But there is less evidence of auditors successfully suggesting that disclosures be removed altogether.

At present auditors can check that no detail is missing or misleading, but may be constrained from making a more positive contribution in the absence of further guidance both for preparers and for auditors. Once again, this is an area where liaison between financial reporting and auditing standard setters might be helpful, in order to develop a framework for making decisions about disclosures. Members of the working party saw this as a key positive area for development. The linkage between the issue of complexity and the need to change regulatory approaches and promote professional judgement is raised in the recent report from the Global Accounting Alliance entitled *Getting to the heart of the issue – Can financial reporting be made simpler and more useful?*

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