

26 June, 2017

Improved Transparency in the Auditor's Report

1. Background

The new and revised auditor reporting standards that require those matters that, in the auditor's professional judgment, were of most significance in the audit be presented in the auditor's report — in addition to an opinion as to whether or not the financial statements are fairly presented — was introduced in the International Standards on Auditing by the International Auditing and Assurance Standards Board ("IAASB") for the purpose of improving the informational value of the auditor's report (hereinafter, referred to as the "improved transparency in the auditor reporting")¹. Major countries in Europe and Asia have adopted the auditing standards and, in the United States, the Public Company Accounting Oversight Board ("PCAOB") has announced to adopt a new audit standard that includes the communication of critical audit matters.²

In Japan, Advisory Council on the Systems of Accounting and Auditing recommended that the "improved transparency in the auditor's report" be considered from the perspective of providing more valuable information on the audit to shareholders and other stakeholders. In response to the recommendation, Keidanren (the Japan Business Federation), the Japan Audit and Supervisory Board Members Association, the Securities Analyst Association of Japan, the Japanese Institute of Certified Public Accountants, and the Financial Services Agency have gathered five times to exchange opinions on this issue since September 2016.

2. Summary of discussion

Regarding the introduction of the "improved transparency in the auditor's report", the following opinions were expressed in the discussion:

- Disclosing information in the auditor's report on those matters that, in the auditor's professional judgment, were of most significance in the audit (Key

¹ In the Recommendation from the Advisory Council on the Systems of Accounting and Auditing (March 2016), auditor's report with KAM, which is also called "extended auditor's report" or "long-form informative auditor's report", is referred as "auditor's report with improved transparency", with a view to emphasizing more informativeness to shareholders.

² The new auditing standards announced by the PCAOB on June 1, 2017, will be effective upon approval by the Securities and Exchange Commission (SEC).

Audit Matters: KAM)³, will enhance the informational value of the auditor's report to the users of the financial statements, and thus is beneficial to deepen their understanding about audit.

- In addition to the above-mentioned enhancement of informational value of the auditor's report, the following are to be expected:
 - Communicating KAM in the auditor's report will facilitate the dialogue between companies and the users of the financial statements.
 - Since audit plans are formulated under the premise that KAM are provided in the audit report, close communication between companies and auditors will be promoted, leading to improve the quality of the audit.

At the same time, participants raised following practical issues.

- In order to provide information that is valuable to the users of the financial statements, what items should be selected as KAM, and how should they be presented? From the very beginning, to what extent can such information be valuable to the users of the financial statements?
- In order for the smooth preparation and disclosure of the auditor's report that includes KAM, what processes are necessary on the sides of auditors and companies, respectively, and between the two parties? How is accountability achieved when the question regarding KAM is raised from the shareholders on occasions such as the annual general meeting?
- How should the disclosure of KAM in the auditor's report be aligned to the disclosure by companies? What kind of process is necessary when there are arguments between an auditor and a company?⁴
- How much additional time does it take to go through the above-mentioned process?

In addition, some participants have the opinion that what kind of benefits the "improved transparency in the auditor's report" brings to each stakeholder should be considered.

In order for the "improved transparency in the auditor's report" to sufficiently

³ KAM are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period and KAM are selected from matters communicated with those charged with governance.

⁴ It is assumed that KAM refer to information already disclosed by the company. The auditor is not precluded to provide original information as KAM in the case that the company has not disclosed the information to be referred to. However, it is considered appropriate for the auditor, initially, to advise the company to make the necessary disclosure.

bring the expected benefit and effects, further consideration on specific issues such as those mentioned above are needed amongst a wider circle of stakeholders.

3. Moving forward

“Improved transparency in the auditor’s report” is a significant agenda for Japanese stakeholders as well as in other capital markets. Thus it is expected that the Business Accounting Council will start detailed discussions on “improved transparency in the auditor’s report”, including considerations on practical issues as mentioned above.

In this regard, it would be beneficial that the Japanese Institute of Certified Public Accountants, with the cooperation of major audit firms, auditee companies, and their audit and supervisory board members, will conduct a trial run of preparing auditor’s report with KAM for previous year’s financial reporting, in order to provide a practical feedback for the Business Accounting Council’s discussion.