



Michael E. Bradbury PhD, FCA, CMA

Professor

Department of Accountancy

Massey University

Private Bag 102 904

North Shore Mail Centre

Albany Campus

Auckland, New Zealand

Tel: +64 9 4140800 Extension 43291

Email: m.e.bradbury@massey.ac.nz

<http://www.massey.ac.nz/massey/expertise/profile.cfm?stref=518930>

Chief Executive
External Reporting Board
PO 11250
Manners St Central
WELLINGTON 6142

By email: submissions@xrb.govt.nz

Dear Warren

ED NZAuASB 2019-1: Amendments to New Zealand Standard on Review Engagements 2410 *Review of Financial Statements Performed By The Independent Auditor of the Entity.*

I attach my comments on ED NZAuASB 2019-1. In general, I think the contents of the ED are relevant, timely and appropriate.

I need to declare that I am an XRB Board member. However, this submission reflects my own personal view rather than those of the XRB or NZ AuASB.

I should also mention that I am **not** an auditor. Hence, my remarks should be taken as those from a financial statement user who has a 'reasonable' but not expert knowledge (IASB Conceptual Framework 2.36).

This submission is structured as follows. I first provide some background evidence on the usefulness of interim reviews, especially in relation to going concern. I then answer the ED questions for respondents. Appendix A provides my reasoning for Question 3.3. Appendix B is my suggested amendments to NZ SRE 2410.

Sincerely

Michael Bradbury

1 October 2019

Background: Recent evidence on the usefulness of interim reports with going concern opinions

By way of background I summarise the results of a recent study that looks at going concern conclusions in interim reports. Hence, it specifically investigates the issue at hand. Grosse and Scott (2019) examine information content of interim review assurances in Australia over the period 2007-2014. They find:

- 292 (7.2%) annual reports receive a going concern opinion (AGCO).
- 259 (6.4%) interim financial statements receive a going concern conclusion (IGCC). These reports show a significant negative market reaction.
- 112 (2.8%) of IGCC follow an annual report that did not receive an AGCO. These reports also show a negative market reaction.
- The market reaction to an AGCO following a IGCC is lower. This indicates that IGCC is an effective early warning signal.
- There is no difference to the market reaction between AGCO and IGCC. Thus, despite different level of assurance, the signals have the same market effect.

Note the study only examined the “average effect” and does not examine which signal (interim or annual) investors found more reliable.

Reference

Grosse, M. and Scott, T. (2019). Disclosure of interim review reports: Do interim going concern conclusions have information content? Working Paper, UTS and AUT.

ED Questions

1. Do you agree with the proposals to incorporate the reporting amendments made to the annual audit report consistently into the interim review report?

Grosse and Scott (2019) show that interim reports are important market signals. Hence, enhancing the credibility of the interim report, is a relevant issue to address.

Amending the auditor's review report on interim financial statements to be consistent with the format and structure of the enhanced audit report is a logical step.

Therefore, in general terms, I support the proposals. Harmonising with Australia is also a major objective.

2. More specifically, do you agree with the proposals to require the auditor to:

- a. Move the review conclusion to the top of the interim review report?
- b. Include the independence statement in the interim review report?
- c. To include the engagement partner's name?
- d. To refer to a "Material Uncertainty Related to Going Concern" rather than an Emphasis of Matter paragraph, when appropriate?

Yes (to all these questions). These logically follow on from the purpose of structuring the interim review to be consistent with the enhanced annual audit report.

3. Questions specific to going concern

- 3.1 Do you agree that the requirement in paragraph 20 of the exposure draft should not make it explicit that the auditor is required to conclude on going concern and that this is implicit in the exposure draft as a whole?

No. I consider the auditor should be required to explicitly conclude on any changes in going concern since the prior annual report and where there is a going concern doubt related to the interim report.

ED-NZ-SRE 2410, Paragraph 20 requires the auditor to "...enquire whether those charged with governance have changed their assessment of the entity's ability to continue as a going concern". Changed from when? Is it the last annual report or the prior (interim) review report? Furthermore, A53 refers to going concern doubt in the "prior audit or review report". More clarity is necessary.

In my view, both 2140.20 and A53 ought to explicitly refer to the last annual report.

My reasoning, is that the primary goal of interim reporting is to present the financial position and performance for the interim period (IAS 34.25). There is no mention of going concern in IAS 34. However, there is a requirement to provide explanations for significant changes *since the end of the last annual report* (IAS 34.15). The nexus between the interim report and the last annual report is also strong in IAS 34.15A, which states that the user of the interim report will have access to the most recent annual report. I think these requirements are so fundamental to interim reporting that NZ SRE 2410 and A53 should make it explicit that the auditor is required to consider any change *since the end of the last annual report* (i.e., to be consistent with IAS 34.15).

A second issue in A53 is whether the ‘prior review report’ refers to (1) last year’s interim review report or (2) the prior review report subsequent to the prior annual report (i.e., in the case of quarterly reporting). As noted above, there is an obligation in IAS 34.25 to use the prior annual report as a baseline to measure change. Given this, the prior year’s interim report would seem to be redundant. However, clarity is required when there is quarterly reporting.

3.2 Do you agree that the review report should include a description of the responsibilities of both management and the auditor in respect of going concern? If not, why not?

Yes. I think both responsibilities are required to be communicated to the reader. This should reduce the communication gap.

3.3 Do you agree with the NZAuASB’s preferred option (in paragraph 28) to describe the auditor’s responsibilities related to going concern? If not, why not?

I think both options have their weakness. In Appendix A I comment on both options and on the interim review report.

4. Do you agree that it is not appropriate to include a section on Other Information in the interim review report? If you disagree, please explain why?

No comment.

5. Do you agree that it is unnecessary to refer to a website when describing the auditor’s responsibilities given that this description is more condensed for a review?

Given that the option to refer to a website when describing the auditor’s responsibility is available for an annual audit, I see no reason why it should not also be an option for an interim review.

6. Do you agree that reporting of Key Review Matters at the interim stage is not appropriate?

I do not see how KAMs can be developed from review procedures (without converting the review into an audit or giving the impression that it is an audit). Furthermore, IAS 34.15A states that the users of the interim report will have access to the most recent annual report. Hence, the reader will have information on typical ‘account-level’ KAMs.

7. Do you agree with the proposed amendments to align with the new ethical framework when encountering non-compliance with laws and regulations, including a reference to guidance in ISA (NZ) 250 rather than including detailed requirements and application material within NZ SRE 2410?

No comment.

8. Do you consider that there are any further amendments required to be made to NZ SRE 2410? If so, please expand on what changes and why such changes are considered necessary?

At a minimum the auditor has a direct requirement to report on *changes* in going concern from the previous assessment. However, I consider NZ SRE 2410 should explicitly consider

where there is going concern doubt expressed in the prior annual financial statements. See reasoning in Appendix B.

9. Do you agree with the proposed effective date? If not, please explain why not.

No comment.

Appendix A: Question 3.3 - Preferred Option

In choosing between these options I examine two features: (1) readability and (2) content.

Readability

I compare option 1 and 2 on readability statistics. I also compare my own suggested wording which is discussed below.

	<u>Option 1</u>	<u>Option 2</u>	<u>My suggestion</u>
Words	131	111	95
Characteristics	660	579	486
Average words per sentence	43.6	17.5	14.2
Flesch readability score	17.8	36.7	43.9
Flesch-Kincaid grade	21.6	12.4	10.6

Options 1 and 2 are similar in terms of the number of words and characteristics. Option 1 has extremely long sentences (average 43.6 words) relative to option 2 (17.5 words). Option 2 is more readable (i.e., it has the higher Flesch readability score) and has a lower Flesch-Kincaid reading grade (e.g., a US reading grade of 12 equals senior year).

In addition to the word analysis, option 2 is more appealing because it has white space and bullet points.

Hence, even if option 1 contained the same content, it needs to be re-written in plain(er) English.

Content

I like the start of option 2 because it continues on from the previous paragraph (“We make enquiries...”) and it focuses on the change. The change from what? Prior annual or prior interim? Thereafter, it moves into third person “the auditor”, rather than “we”, which reduces readability.

Suggested wording

The following is an attempt to capture the auditor’s responsibilities and improve readability (relative to the options in the ED).

We enquire if management have changed their assessment of the entity’s ability to continue as a going concern.

If a matter comes to our attention that causes us to believe that a material going concern uncertainty exists, we:

- Enquire of management’s plans for future actions and the feasibility of those plans to improve the situation; and
- Consider the adequacy of the financial statement disclosures.

Our review opinion is based on the procedures performed to the date of the review report. Future events or conditions may cause the entity to cease continuing as a going concern.

The readability statistics are higher and the reading grade is lower for the suggested wording.

However, there is no point in re-writing the auditor’s responsibilities without re-examining the whole of the audit review opinion for plain English. In my view the audit report fails to communicate effectively because it is written to reduce auditors’ liability rather than communicate to the financial statement readers. The following is my attempt at re-writing the audit report in plain English. However, if this approach is adopted, I recommend that a professional copy editor is employed.

NZ SRE 2410	Plain English Example
<p>INDEPENDENT AUDITOR’S REVIEW REPORT To [Appropriate Addressee] Report on the [appropriate title for the financial statements] Financial Statements</p>	<p>INDEPENDENT AUDITOR’S REVIEW REPORT To [Appropriate Addressee] Report on the [appropriate title for the financial statements] Financial Statements</p>
<p>Conclusion We have reviewed the accompanying [period] financial statements of [name of entity], which comprise the statement of financial position as at [date], and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the [period] ended on that date, and a summary of significant accounting policies and other explanatory information.</p>	<p>Conclusion We have reviewed the accompanying [period] financial statements of [name of entity], which comprise the statement of financial position as at [date], and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the [period] ended on that date, and a summary of significant accounting policies and other explanatory information.</p>
<p>Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that these [period] financial statements of [name of entity] are not prepared, in all material respects, in accordance with [applicable financial reporting framework].</p>	<p>Based on our review, nothing has come to our attention that causes us to believe that these [period] financial statements of [name of entity] are not prepared, in all material respects, in accordance with [applicable financial reporting framework].</p>
<p>Basis for Conclusion We conducted our review in accordance with NZ SRE 2410 Review of Financial Statements Performed by the Independent Auditor of the Entity. Our responsibilities are further described in the Auditor’s Responsibilities for the Review of the Financial Statements section of our report. We are independent of the [entity] in accordance with the relevant ethical requirements in New Zealand, and we We have fulfilled our other ethical responsibilities in accordance with the ethical requirements relevant to the audit of the annual financial statements. Other than in our capacity as assurance practitioner we have no</p>	<p>Basis for Conclusion We conducted our review in accordance with NZ SRE 2410 Review of Financial Statements Performed by the Independent Auditor of the Entity. Other than in our capacity as assurance practitioner we have no relationship with, or interests in, [name of entity]. We are independent of the [entity] and have fulfilled our responsibilities in accordance relevant ethical requirements in New Zealand.</p>

relationship with, or interests in, [name of entity]. [
<p>[Title of those charged with governance] Responsibility for the [period] Financial Statements</p> <p>The [title of those charged with governance] of the [type of entity] are responsible, on behalf of the [entity], for the preparation [and fair presentation] of the [period] financial statements in accordance with the [applicable financial reporting framework] and for such internal control as the directors [those charged with governance] determine is necessary to enable the preparation [and fair presentation] of the [period] financial statements that are free from material misstatement, whether due to fraud or error.</p>	<p>[Title of those charged with governance] Responsibility for the [period] Financial Statements</p> <p>The [title of those charged with governance] of the [type of entity] are responsible for the preparation [and fair presentation] of the [period] financial statements in accordance with the [applicable financial reporting framework].</p> <p>The [title of those charged with governance] are also responsible for establishing internal controls to enable the preparation [and fair presentation] of the [period] financial statements that are free from material misstatement, whether due to fraud or error.</p>
<p>In preparing the financial statements, [those charged with governance] are responsible on behalf of the entity for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless [those charged with governance] either intend to liquidate the entity or to cease operations, or have no realistic alternative but to do so.</p>	<p>In preparing the financial statements, the [those charged with governance] are responsible for assessing the entity's ability to continue as a going concern and make appropriate disclosures.</p>
<p>Auditor's Responsibilities for the Review of the Financial Statements</p> <p>Our responsibility is to express a conclusion on the [period] financial statements based on our review. NZ SRE 2410 requires us to conclude whether anything has come to our attention that causes us to believe that the [period] financial statements, taken as a whole, are not prepared in all material respects, in accordance with the [applicable financial reporting framework].</p>	<p>Auditor's Responsibilities for the Review of the Financial Statements</p> <p>Our responsibility is to express a conclusion on the [period] financial statements based on our review. NZ SRE 2410 requires us to conclude whether anything has come to our attention that causes us to believe that the [period] financial statements, taken as a whole, are not prepared in all material respects, in accordance with the [applicable financial reporting framework].</p>
<p>A review of [period] financial statements in accordance with NZ SRE 2410 is a limited assurance engagement. We perform procedures, primarily consisting of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review</p>	<p>A review of [period] financial statements in accordance with NZ SRE 2410 is a limited assurance engagement. We perform procedures, consisting of:</p> <ul style="list-style-type: none"> • Making enquiries of persons responsible for financial and accounting matters, and

<p>procedures. The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing (New Zealand) and consequently does not enable us to obtain assurance that we might identify in an audit. Accordingly, we do not express an audit opinion on those [period] financial statements.</p>	<ul style="list-style-type: none"> • Applying analytical and other review procedures. <p>These procedures are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing (New Zealand). Consequently they do not enable us to obtain assurance that we might identify in an audit.</p>
<p>Based on the review procedures performed, we conclude whether anything has come to our attention that causes us to believe that the use of the going concern basis of accounting by [those charged with governance] is not appropriate and whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If a matter comes to our attention that causes us to believe that a material uncertainty related to going concern exists, we are required to draw attention in our review report to the related disclosures in the [period] financial statements or, if such disclosures are inadequate, to modify our conclusion. Our conclusions are based on the procedures performed up to the date of the review report. However, future events or conditions may cause the entity to cease to continue as a going concern.</p>	<p>We enquire if management have changed their assessment of the entity's ability to continue as a going concern.</p> <p>If a matter comes to our attention that causes us to believe that a material going concern uncertainty exists, we:</p> <ul style="list-style-type: none"> • Enquire of management's plans for future actions and the feasibility of those plans to improve the situation; and • Consider the adequacy of the financial statement disclosures. <p>Our review opinion is based on the procedures performed to the date of the review report. Future events or conditions may cause the entity to cease continuing as a going concern.</p>

Appendix B: Amendments to NZ SRE 2410

In relation to going concern, a major focus of the interim report (for both management and auditor) is to report any change in status since the last annual report. There are four possible outcomes:

Possible outcomes: Going Concern Opinions (GCO)

<u>Outcomes</u>	<u>Annual Report</u>	<u>Interim Report</u>	<u>Percentage of population 2007-2014 (Grosse and Scott 2019)</u>
1	Clean	Clean	91.1%
2	Clean	GCO	2.8%
3	GCO	Clean	2.5%
4	GCO	GCO	3.6%

Outcomes 2 and 3 are important because there has been a change in going concern doubt since the prior annual report.

However, outcome 4 is also relevant, even if there has been no change. It may not be a major problem because NZ SRE 2410.20 uses the inclusive phrase “or other review procedures”. However, outcome 4 seems to be so important that NZ SRE 2410 should explicitly cover this situation.

Conclusion

At a minimum the auditor has a direct requirement to report on **changes** in going concern from the previous assessment.

However, I consider NZ SRE 2410 should explicitly consider the situation where there is going concern doubt expressed in the prior annual financial statements.

In addition, it might be worth considering the prior interim report that is subsequent to prior annual report (i.e., where there is quarterly reporting).