

FEEDBACK PAPER ON THE EXPOSURE DRAFT OF INTERNATIONAL STANDARD ON AUDITING (UK AND IRELAND) 700 (REVISED): THE AUDITOR’S REPORT ON FINANCIAL STATEMENTS

Introduction

- 1.1 In September 2008 the Auditing Practices Board (APB) issued for public comment an Exposure Draft of proposed International Standard on Auditing (UK and Ireland) 700 (Revised).
- 1.2 The proposals for revising ISA (UK and Ireland) 700, set out in the Exposure Draft, were derived from the findings arising from a Discussion Paper issued by the APB in December 2007 entitled “The Auditor’s Report: A time for change?” The Discussion Paper had sought views on what steps needed to be taken to reflect the coming into force of the Companies Act 2006 (CA 2006) and whether other, more wide ranging, changes should be made to the form and content of the auditor’s report.
- 1.3 The Discussion Paper had, in turn, been prepared in the light of responses to an earlier paper issued by the Financial Reporting Council (FRC) on the subject of “Promoting Audit Quality”. The responses revealed that a number of stakeholder groups considered auditor’s reports to be overly legalistic and to contain caveats and provisos that limit their usefulness.
- 1.4 The APB illustrated the requirements of the Exposure Draft by providing examples of the more concise auditor’s report to accompany the Exposure Draft.
- 1.5 The APB received 27 comment letters from the following stakeholder groups¹:
- | | |
|---|-----------|
| • Institutional investors | 3 |
| • Organisations representing preparers | 2 |
| • Auditing firms and accountancy bodies | 14 |
| • Public sector bodies | 5 |
| • Individuals | <u>3</u> |
| | <u>27</u> |
- 1.6 In March 2009 the APB issued ISA (UK and Ireland) 700 (Revised) “The Auditor’s Report on Financial Statements”. The purpose of this Paper is to explain the principal changes that APB made to the Exposure Draft to reflect comments received.

Extent of overall support for revising ISA (UK and Ireland) 700

- 2.1 63% of the commentators expressed support for APB issuing a revision of ISA (UK and Ireland) 700 based on the Exposure Draft. 26% of commentators were opposed.

¹ A full list of respondents is set out in the Appendix.

- 2.2 All of those expressing opposition were accountancy firms and accountancy bodies. They took the view that APB should make only the minimum changes to the auditor's report needed to comply with the requirements of the Companies Act 2006, and then in the longer term seek to lead the debate and influence the international agenda, rather than make changes outside of EU and IAASB processes. The general thrust of their comments was that the firms considered it undesirable for APB to be taking steps that might be perceived as being contrary to international harmonisation. Specifically, one commentator considered that a stand-alone ISA (UK and Ireland) 700 might undermine the ISA adoption process and another pointed out the strong international support that exists for ISAs as issued by the IAASB.
- 2.3 More specifically these firms and bodies were not supportive of the description of the scope of an audit being cross referred from auditor's reports to the APB's web-site. Some of them indicated that they were not prepared to cross reference to the APB's web-site in auditor's reports that they would issue. Some commented on the risk of a widening of the expectations gap whilst others were concerned that such a report may not satisfy legal requirements or might lack credibility.
- 2.4 There was however no consensus amongst the accountancy firms and bodies with 50% of this group broadly in favour of the proposals in the Exposure Draft and 50% broadly opposed. One firm stated that the ED was a useful first step but indicated that they would have liked the APB to have been more radical. Regarding cross referring to the APB's web-site another firm expressed the view that this should be compulsory.
- 2.5 The APB considered the arguments of those expressing opposition to, and support for, the Exposure Draft carefully and concluded that there would be benefit to APB putting its ideas into practice. The APB believes that there is a window of opportunity during which it can influence international decisions on the form and content of the auditor's report, especially if it is able to demonstrate that implementation of its ideas in the UK is found to be beneficial by investors and others.
- 2.6 The APB, therefore, intends to monitor the extent to which certain of the optional aspects of ISA (UK and Ireland) 700 (Revised) are taken up by auditors, and investor reactions to these.

Focus on UK companies

- 3.1 The catalyst for amending ISA (UK and Ireland) 700 was the implementation of the Companies Act 2006 and responding to the views of institutional investors. APB has decided to establish a two stage implementation plan.
- 3.2 The effective date of ISA (UK and Ireland) 700 (Revised) for UK companies (except for those that are charities) is for accounting periods commencing on or

after 6 April 2008 and ending on or after 5 April 2009².

- 3.3 For other UK entities the effective date is for periods ending on after 15 December 2010. This is the same effective date as will apply to the Clarified ISAs (UK and Ireland) that are presently being exposed by the APB.

Republic of Ireland

- 4.1 Feedback from commentators in the Republic of Ireland indicated that they are expecting significant changes in Irish Company Law to be made in the near future and wanted to wait for these before making changes to Irish auditor's reports. The APB agreed that it was desirable to avoid the risk of changing the auditor's report twice in consecutive years and is, therefore, monitoring developments in Irish Law which may have an effect on the content or structure of auditor's reports.
- 4.2 APB will make an announcement concerning the applicability of ISA (UK and Ireland) 700 (Revised) in the Republic of Ireland when there is more certainty about the legal position. In the meantime the version of ISA (UK and Ireland) 700 that was effective for periods commencing on or after 15 December 2004 remains in effect with respect to Irish auditor's reports.

Redrafting the proposed ISA to address "true and fair" and "compliance" frameworks separately.

- 5.1 The Exposure Draft (at paragraph 2) indicated that it had been drafted in the context of audits where the auditor is required to report on whether the financial statements give a true and fair view and noted that it may be adapted to compliance audits where the auditor is not required to express an opinion as to whether the financial statements give a true and fair view.
- 5.2 Some commentators were unclear as to what was meant by the term "compliance audit" whilst others suggested that the proposed ISA would benefit from distinguishing more clearly between requirements that apply to audits where the auditor reports in true and fair terms and compliance audits.
- 5.3 To respond to these concerns the proposed ISA has been redrafted to provide a clearer distinction between requirements applicable to "true and fair frameworks" and requirements applicable to "compliance frameworks". This is explained in new paragraph 2 of ISA (UK and Ireland) 700 (Revised) and is reflected in the drafting of paragraph 4, paragraphs 17 and 18, and paragraphs 42 and 43. (Paragraphs 18 and 43 apply to true and fair frameworks only.)

Description of the scope of an audit

- 6.1 An important innovation to streamline the auditor's report was the proposed requirement in paragraph 16 of the Exposure Draft to permit the auditor's report to cross refer to a relevant "Statement of the Scope of an Audit" maintained on the APB's web-site.

² For UK companies issuing financial statements for periods commencing on or after 6 April 2008 and ending before 5 April 2009 guidance on the wording of auditor's reports is provided by Bulletin 2008/8 "Auditor's Reports for Short Accounting Periods in Compliance with the United Kingdom Companies Act 2006".

- 6.2 Moving the description of the scope of an audit from the auditor's report to the APB's web-site provided the additional benefit of enabling the description of the scope of an audit to provide a fuller explanation than that included in the auditor's report, which has necessarily been only a précis of the principal aspects.
- 6.3 The long-form version of the scope of an audit was received favourably by a number of commentators who considered that it would make a helpful contribution to closing the so-called "expectation gap".
- 6.4 A number of commentators observed, however, that the APB's proposal would give rise to descriptions of the scope of the audit that differed in length (and in substance) dependent on whether the description was included within the auditor's report or reference was made to the longer version on the APB's web-site. Some commentators further suggested that difficulties may arise if an auditor is asked to read out the auditor's report, for example at an AGM.
- 6.5 Other commentators, including a number of public sector bodies, suggested that the ISA should include a third option of including the description of the scope of the audit in the Annual Report. Some of these commentators suggested that there may be benefit in the description of directors' responsibilities and the scope of the audit being included next to each other in the Annual Report.
- 6.6 In response to these comments the APB made a number of changes to ISA (UK and Ireland) 700 (Revised). These were:
- (a) To permit a third option of the auditor's report cross referring to a "Statement of the Scope of an Audit" that is included elsewhere within the Annual Report. (See paragraph 14(b)). For the avoidance of doubt, guidance has been provided to the effect that the description of the scope of the audit is determined by the auditor (see paragraph 16).
 - (b) To mandate the wording that should be used when the description of the scope of an audit is included in the auditor's report (see paragraph 14). This wording has also been embedded in the long-form version of the "Scope of an Audit" posted to the APB's web site. In mandating the wording the APB sought to:
 - (i) mitigate the risk identified by commentators of inconsistencies arising between statements of the scope of the audit dependent on where the statement is presented; and
 - (ii) ensure that descriptions within auditor's reports were consistent with each other and as brief as possible.
- 6.7 Effective 26 March 2009, the APB has established a separate section of its web site which includes various descriptions of the scope of an audit. This section currently contains:
- (a) a description of the Scope of an Audit of a United Kingdom publicly traded company or group (www.frc.org.uk/apb/scope/UKP);
 - (b) a description of the Scope of an Audit of a United Kingdom non-publicly traded company or group (www.frc.org.uk/apb/scope/UKNP).
- 6.8 The descriptions on the APB's web-site include, as a shaded paragraph, the wording for the scope of an audit set out in paragraph 14 of ISA (UK and

Ireland) 700 (Revised). If the auditor's report is required to be read out, only the shaded paragraph is to be regarded as forming part of the auditor's report for that purpose.

Public sector opinion on “regularity”

- 7.1 In the Public sector the audit mandate normally requires the auditor to express an opinion on “regularity”. “Regularity” is the requirement that financial transactions are in accordance with the legislation authorising them. A number of public sector bodies expressed the view that the opinion on “regularity” should not be dealt with in the second part of the auditor's report dealing with “Other reporting responsibilities”. This is because regularity is as important in the Public Sector as the true and fair concept is in other sectors.
- 7.2 The APB responded to this concern by establishing a new requirement that the opinion on regularity should be set out in a discrete section of the auditor's report between the opinion on the financial statements and the opinion on “Other reporting responsibilities”. (See paragraph 25 of ISA (UK and Ireland) 700 (Revised)).

Other reporting responsibilities, and concluding where such responsibilities are reported on by exception

- 8.1 The Exposure draft included at paragraph 25 the requirement:

“When the auditor addresses other reporting responsibilities within the auditor's report on the financial statements, the opinion arising from such other reporting responsibilities should be set out in a separate section of the auditor's report following the opinion on the financial statements”

The example auditor's reports issued with the Exposure Draft to illustrate its requirements, included with respect to those matters where the auditor is required to report by exception, the conclusion “We have nothing to report in respect of these responsibilities”.

- 8.2 A number of commentators observed that the requirement in the Exposure Draft did not explicitly require:
- that all “other reporting responsibilities” be addressed in the auditor's report; and
 - that a conclusion be provided in respect of those matters where the auditor is required to report by exception. (Five commentators expressed opposition to auditor's being required to express a conclusion on such matters).
- 8.3 In ISA (UK and Ireland) 700 (Revised) the APB has sought to clarify the requirements and ensure that the requirements are consistent with the example auditor's reports.
- 8.4 Paragraph 26, therefore, requires the auditor to address other reporting responsibilities in a separate section of the auditor's report following the opinion on the financial statements (or if there is one the opinion on regularity).

- 8.5 Paragraph 29 requires, where the auditor is required to report on certain matters by exception, that:
- (a) those matters should be described under the heading “Matters on which we are required to report by exception”; and
 - (b) that the auditor should incorporate a suitable conclusion in respect of such matters.
- 8.6 Paragraph 30 provides guidance that such a conclusion could be expressed in the form of the following phrase “We have nothing to report in respect of the following...”.

Ordering of the opinion on the financial statements

- 9.1 The illustrative auditor’s opinion on the financial statements included with the Exposure Draft presented the three elements of the auditor’s report required by CA 2006 as separate bullet points, but in a different sequence to that used in CA 2006. The sequence in CA 2006 places references to the true and fair view in the first bullet point, whereas, in the Exposure Draft, the APB expressed the view that placing the reference to the true and fair view as the final bullet point would result in the most logical sequence as it emphasises the importance of the auditor making this final judgment.
- 9.2 Views on this issue were almost evenly divided. However, as a small majority favoured using the same ordering as used by CA 2006 the APB has modified its examples to reflect this view.

Making auditor’s reports more informative

- 10.1 Making the auditor’s report more concise is the first phase of APB’s work on the auditor’s report. The second phase will be for APB to undertake research to better understand what can realistically be done to make auditor’s reports more informative. In the short term APB wished to make clear that ISA (UK and Ireland) 700 (Revised) does not preclude auditors from including additional comment in the auditor’s report to highlight matters which they regard as relevant to a proper understanding of their work. To facilitate the inclusion of such additional comments in the auditor’s report APB has introduced the following requirement at paragraph 55.

“55 If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor’s judgment, is relevant to users’ understanding of the audit, the auditor’s responsibilities or the auditor’s report and this is not prohibited by law or regulation, the auditor should do so in a paragraph in the auditor’s report, with the heading “Other Matter”, or other appropriate heading.”

- 10.2 This requirement is derived from ISA 706 “Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report”.

RESPONDENTS TO ISA (UK AND IRELAND) 700 (REVISED)

Institutional investors

- 1) Association of British Insurers (ABI)
- 2) Hermes
- 3) Standard Life Investments

Organisations representing preparers of financial statements

- 4) Confederation of British Industry (CBI)
- 5) Quoted Companies Alliance (QCA)

Auditing firms and accountancy bodies

- 6) The Association of Chartered Certified Accountants (ACCA)
- 7) The Association of International Accountants (AIA)
- 8) Baker Tilly UK Audit LLP
- 9) The Chartered Institute of Public Finance and Accountancy (CIPFA)
- 10) Deloitte & Touche LLP
- 11) Grant Thornton UK LLP
- 12) The Institute of Chartered Accountants in England & Wales (ICAEW)
- 13) The Institute of Chartered Accountants in Ireland (ICAI)
- 14) The Institute of Chartered Accountants of Scotland (ICAS)
- 15) The Institute of Certified Public Accountants in Ireland
- 16) KPMG LLP
- 17) London Society of Chartered Accountants
- 18) Mazars LLP
- 19) PricewaterhouseCoopers LLP

Public sector bodies

- 20) Audit Commission
- 21) Audit Scotland
- 22) National Audit Office
- 23) Northern Ireland Audit Office
- 24) Wales Audit Office

Private individuals

- 25) Mr. Duncan Alexander
- 26) Mr. PL Bunting
- 27) Dr. Andrew Higson, Loughborough University

(Copies of the comment letters are available on the APB's web site at <http://www.frc.org.uk/apb/publications/isaresponse.cfm>)