

FEEDBACK PAPER ON “THE AUDITOR’S REPORT: A TIME FOR CHANGE?” DISCUSSION PAPER AND APB FUTURE PLANS REGARDING THE FORM AND CONTENT OF UK AUDITOR’S REPORTS.

Introduction

- 1.1 In December 2007 the Auditing Practices Board (APB) issued a Discussion Paper “The Auditor’s Report: A time for change?” The Discussion Paper sought views on what changes were needed to existing UK auditor’s reports 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.
- 1.2 “The Auditor’s Report: A time for change?” had been prepared in the light of responses to an earlier Financial Reporting Council (FRC) paper¹ which revealed a variety of views on the usefulness of the auditor’s report. These responses suggested that a number of stakeholder groups considered current auditor’s reports to be overly legalistic and to contain so many caveats and provisos that their usefulness was limited.
- 1.3 “The Auditor’s Report: A time for change?” noted that the extent to which the content of UK auditor’s reports can be determined by the APB alone is constrained by decisions, yet to be taken, by the European Commission (EC) with respect to the Statutory Audit Directive. Under the Statutory Audit Directive the EC is able either to require auditors to apply those international auditing standards that are adopted by the Commission (This could be the Clarity version of ISA 700), or to develop its own auditor’s report². Any such “European Auditor’s Report” would have to be applied in all European countries, including the UK and Ireland.
- 1.4 The purpose of this Paper is to:
 - (a) summarise the comments received in response to “The Auditor’s Report: A time for change?”, and
 - (b) explain the actions that the APB intends to take regarding the form and content of UK and Irish auditor’s reports.

¹ “Promoting Audit Quality” November 2006.

² Article 28 of the Statutory Audit Directive specifies that the Commission may “adopt a common standard for audit reports for annual or consolidated accounts which have been prepared in accordance with approved international accounting standards, in order to enhance public confidence in the audit function”.

Comments received on the Discussion Paper “The Auditor’s Report: A Time for change?”

2.1 The APB received 31 comment letters from the following stakeholder groups³:

• Institutional investors	3
• Organisations representing preparers	3
• Auditing firms and accountancy bodies	16
• Public sector bodies	4
• Individual responses	<u>5</u>
	<u>31</u>

2.2 In addition an open meeting was held on 26 March 2008 to obtain views of stakeholders. Not all those who attended the meeting responded in writing to the APB.

2.3 While inevitably views varied, there was quite a high degree of consistency in the responses within the different stakeholder groups and quite marked differences of view between the stakeholder groups. The views expressed are summarised below.

Institutional investors

2.4 Although the number of responses from institutional investors was relatively small the responses that were received were from organisations representing major investors in companies whose securities are traded on regulated markets. These organisations took the view that the auditor’s report should be made more informative and that this could be achieved through a more discursive approach, balanced by a reduction in the current content which appears to be designed primarily to minimise prospective liability.

2.5 One investor called for a move to an auditor’s report which was genuinely a report to shareholders of the findings of the audit and which provided shareholders with some insight into the company and into the quality of work which the auditors have carried out.

2.6 Another response suggested that one way of providing information of this nature was to make greater use of “Emphasis of Matter” paragraphs and called for the requirements for such paragraphs to be drawn more widely.

2.7 On the specifics of the auditor’s report institutional investors generally:

- (a) favoured the auditor making an explicit statement that adequate accounting records had been kept;
- (b) supported the auditor’s report stating that there were no matters that need to be reported on by exception; and
- (c) believed that auditor reports should include a statement that there are no matters that the auditor wishes to emphasise.

³ A full list of respondents is set out in Appendix 1

Organisations representing preparers of financial statements.

- 2.8 Organisations representing preparers concluded that this is the time for change and the APB should shorten auditor's reports to make them clearer and less ambiguous. They took the view that the argument that there is an expectations gap that needs to be addressed by setting out the respective responsibilities of directors and auditors seems much less clear-cut following all the recent debates and publicity surrounding director and auditor responsibilities and recent regulatory developments.
- 2.9 On the specifics of the auditor's report the views of preparers were less supportive of change. In particular they did not generally support:
- (a) adding more company specific narrative on the bases that financial statements should contain all relevant disclosures;
 - (b) the auditor making an explicit statement that adequate accounting records had been kept;
 - (c) stating that there were no matters that need to be reported on by exception; or
 - (d) including a statement that there are no matters that the auditor wishes to emphasise.

Auditing firms and accountancy bodies.

- 2.10 The principal concern of most of the auditing firms and accountancy bodies was that UK auditing standards should not diverge from International Standards on Auditing (ISAs) to the extent that the ability of the UK to demonstrate compliance with international standards (especially if they were to be adopted for use within the EU) would be put at risk.
- 2.11 These respondents also argued that, because of the increasing globalisation of capital markets, it is important to achieve international harmonisation of auditor's reports to the maximum extent possible and that this was best achieved through adoption of ISA 700.
- 2.12 Furthermore, to minimise the frequency of significant change to auditor's reports in the future, at this stage, they recommended that the APB only make the minimum changes needed to comply with the requirements of CA 2006 and wait until there is clarity on the EU direction before making more significant changes. One audit firm commented that it would add further confusion to the market if APB was to make sweeping changes to the auditor's report only for further changes to be necessary within a couple of years.
- 2.13 Many, although not all, of the auditing firms and accountancy bodies were also concerned at proposals that could be thought to extend the scope of the auditor's responsibilities. In particular they did not:
- (a) support the auditor making an explicit statement as to whether adequate accounting records had been kept, as this would be going beyond the CA 2006 requirements;
 - (b) support the auditor's report stating that there were no matters that need to be reported on by exception;

- (c) believe that auditor reports should include a statement that there are no matters that the auditor wishes to emphasise (Emphasis of Matter paragraphs); and
 - (d) favour adding more company specific narrative on the bases that financial statements should contain all relevant disclosures and that additional narrative would detract from clarity and the appropriate focus on the "truth and fairness" of the financial statements.
- 2.14 A number of auditing firms and accountancy bodies observed that, based on legal advice, the "Bannerman disclaimer" should not be removed from the auditor's report⁴.
- 2.15 A number of auditing firms and accountancy bodies emphasised the importance of APB issuing guidance, as a matter of urgency on reports under CA 2006 for "short accounting periods"⁵.
- 2.16 A few auditing firms were more positive about possible changes to the auditor's report. In particular one audit firm took the view that auditor's reports have become too lengthy and complex and that the APB should take the opportunity, whilst amending its auditor's reports to reflect the CA 2006, to shorten significantly auditor's reports to achieve clarity. This firm took the view that virtually all of the material addressing expectation gaps could be removed; some other audit firms supported this approach provided that such information was readily available to users from another source.

Public sector bodies.

- 2.17 Public sector responses supported change and the view was expressed that the level of detail currently required in auditor's reports detracted from the auditor's opinion on the accounts. That said there was a call for the APB to have regard to the differing reporting frameworks of public sector auditors (eg the need to report on the regularity of expenditure) and a concern was expressed that over-simplification of the auditor's report could allow a public sector expectation gap to develop. With this in mind, it was noted that proposals for separate publication of information regarding management and auditor responsibilities would need to be carefully considered as to the impact this could have on the public sector audience.

⁴ A number of accountancy bodies have issued guidance recommending to their members that an additional disclaimer paragraph be included in auditor's reports. The APB does not participate in the auditing profession's risk management activities and accordingly has not promulgated this guidance.

⁵ Short accounting periods are accounting periods commencing on or after 6 April 2008 (and for which therefore the new requirements of CA 2006 apply) but ending before 5 April 2009.

Individual responses

- 2.18 A number of individual responses were received which expressed views on specific issues. Issues commented on included the need to build the auditor's report from a clear statement of the degree of auditor liability, the benefits of the current French model and the possible development of a financial statements "expectation gap" as a result of increasing requirements for fair values in accounting standards.

Actions that APB intends to take in response to comments received

- 3.1 The APB agrees with the view of institutional investors, organisations representing preparers, public sector bodies and some accounting firms and individuals that this is "the time for change" and that action should be taken to change auditor reports. The APB has therefore decided to use the introduction of CA 2006 as an appropriate opportunity for making changes to UK auditor's reports.
- 3.2 Responses to the Discussion Paper suggest that there are two key issues:
- (a) eliminating unnecessary wording; and
 - (b) making auditor's reports more informative.
- 3.3 Unnecessary wording was thought to exist in current auditor's reports due to attempts made by past standard setters (including the APB) to minimise the so called "expectation gap" by including in the auditor's report wording to describe the directors' and auditor's responsibilities and to describe what an audit involves. A number of commentators observed that such information was no longer necessary. While some other commentators thought the information was still necessary, they recognised that, especially as financial statements are now often accessed through the internet, there were other ways in which the information could be provided. The new responsibility statements required by the Disclosure and Transparency Rules have made the extant wording in the auditor's report on directors' responsibilities somewhat redundant and potentially confusing.
- 3.4 A greater challenge exists with regard to making auditor's reports more informative. Because of this the APB intends to explore this issue further and participate in related international initiatives with a view to contributing to future changes in international auditing standards.
- 3.5 The APB has therefore decided to adopt a two phase strategy involving:
- (a) revising ISA (UK and Ireland) 700 to facilitate, for audits of accounting periods ending on or after 5 April 2009, audit firms to issue "streamlined" auditor's reports⁶, and
 - (b) commencing a research programme to establish whether there is consensus as to what sort of additional information in auditor's reports would be of assistance to investors and then to explore the feasibility of it being provided.

⁶ These examples are very similar to Example 2 in "The Auditor's Report: A time for change?"

- 3.6 One of the benefits of adopting this two phase strategy is that the APB believes that phase 1 can be done in a way that will mean that UK auditing standards remain “ISA compliant”, thereby alleviating one of the main concerns expressed by the majority of auditing firms and accountancy bodies (see paragraph 2.10).
- 3.7 Many of the audit firms and accountancy bodies also wished to minimise the number of future changes to the auditor’s report. The APB shares the objective of minimising the number of future changes in the auditor’s report, but based on the following analysis, believes that a new UK standard would have a “shelf-life” of at least 3 years:
- The APB believes that, when finalising the Clarity version of ISA 700 later in 2008, it is unlikely that the IAASB will make significant changes to the exposure draft issued in August 2007. The IAASB has, however, announced⁷ that in early 2009 it will look again at ISA 700 in the light of research and other developments. This could lead to an exposure draft of further revisions to ISA 700 being issued in 2011 which might therefore be finalised in 2012 and become effective in 2013.
 - The form and content of the auditor’s report is likely to be one of the issues to be discussed in detail as part of the European adoption process for the ISAs. The APB believes that:
 - (a) it is unlikely that the EC will have adopted the ISAs for application in 2010,
 - (b) if the EC adopts the ISAs in 2011 there is likely to be a transitional period during which APB will be able to, and may decide to, retain its existing auditor’s reports, and
 - (c) any such transitional period is also likely to apply to any “European Auditor’s Report” developed by the EC.
- 3.8 The APB has therefore concluded that there is a “window of opportunity” during which it can influence international decisions on the auditor’s report by having implemented a “streamlined” auditor’s report and having commenced research to better understand what can realistically be done to make auditor’s report more informative.
- 3.9 The APB also believes that this approach will have the benefit of easing the transition of UK auditing standards to the Clarity ISAs at an early stage as, unless APB takes action on auditor’s reports, there is a danger that disenchantment with the current version of ISA 700 will act as an impediment to the adoption of the Clarity ISAs⁸.
- 3.10 The APB therefore intends to:
- (a) issue for exposure ISA (UK and Ireland) 700 (Revised) “The Auditor’s Report on Financial Statements” to take effect for accounting periods ending on, or after, 5 April 2009 to facilitate a “streamlining” of existing UK and Irish auditor’s reports;

⁷ In its Strategy and Work Program, 2009-2011

⁸ The APB consulted on the adoption of ISA 700 (revised) in 2005. Reasons why the APB deferred adoption of ISA 700 (Revised) are described in paragraph 2.17 to 2.19 of “The Auditor’s Report: A time for change?”.

- (b) issue an updated Bulletin 2006/6 which contains illustrative examples of auditor's reports in spring 2009.
- (c) issue on its website in spring 2009 a summary of auditor responsibilities and a description of an audit to allow such material to be cross referenced by future UK and Irish auditor's reports;
- (d) issue a Bulletin in summer 2008 providing illustrative auditor's reports for accounting periods commencing on or after 6 April 2008 but ending before 5 April 2009 (ie "short accounting periods")⁹;
- (e) initiate research to better understand what can realistically be done to make auditor's report more informative; and
- (f) progress guidance on adequate accounting records together with the broader FRC initiative.

Further information on these planned actions is set out below.

Exposure Draft of ISA (UK and Ireland) 700 (Revised) "The Auditor's Report on Financial Statements"

- 3.11 ISA (UK and Ireland) 700, which was issued in December 2004, specifies a number of minimum requirements for UK auditor's reports. In order to achieve the desired simplification of auditor's reports some of these minimum requirements need to be withdrawn.
- 3.12 It is planned that ISA (UK and Ireland) 700 (Revised) will be issued in spring 2009 and take effect for accounting periods ending on, or after, 5 April 2009 to facilitate a "streamlining" of existing UK and Irish auditor's as soon as the CA 2006 requirements apply to full accounting periods.
- 3.13 The APB will soon be consulting on plans to adopt the Clarified ISAs within the UK and Ireland. Irrespective of whether APB adopts the Clarity ISAs it is anticipated that the basic requirements of ISA (UK and Ireland) 700 (Revised) should apply in the foreseeable future¹⁰ as APB plans to take advantage of the provisions set out in paragraphs 40 and 42 of the exposure draft of the Clarity version of ISA 700¹¹. These paragraphs, which are reproduced in Appendix 2 of this paper, allow a statement of compliance with ISAs to be made where, because of national law or auditing standards, a different auditor's report is required.

Updated Bulletin 2006/6 to be issued in spring 2009.

- 3.14 Bulletin 2006/6 contains illustrative examples of auditor's reports. It is planned that the examples in this Bulletin would be updated to reflect the requirements of ISA (UK and Ireland) 700 (Revised)¹².

⁹ Bulletin 2008/8 "Auditor's reports for short accounting periods in compliance with the United Kingdom Companies Act 2006"

¹⁰ Although conforming changes will likely be needed to it if, and when, APB adopts the Clarity ISAs.

¹¹ The APB expects these paragraphs to be promulgated, in substance, in the final Clarity version of ISA 700.

¹² Bulletin 2006/1 relating to Ireland would be similarly updated.

- 3.15 The updated Bulletin 2006/6 will be expanded to include example auditor's reports of certain specialised audits (for example charities and pension schemes) to assist audit firms implement the new regime during 2009.

Statement(s) of the scope of an audit and the auditor's reporting responsibilities to be issued in spring 2009.

- 3.16 APB plans to publish on its website a Statement of the scope of an audit and the auditor's reporting responsibilities to allow such material to be cross referred to from auditor's reports. APB expects that audit firms will, in the short term, wish to cross refer to the information on APB's website. In the medium term there may be the potential for alternatives mechanisms for providing this information.
- 3.17 Descriptions of auditor's reporting responsibilities and the nature of an audit were arguably included in auditor's reports to help overcome aspects of the expectation gap. Such descriptions were curtailed because of the desire to keep published auditor's reports as short as was practical. Providing this information on a website gives the APB the opportunity of providing rather more comprehensive descriptions to help users of auditor's reports enhance their understanding of those matters.
- 3.18 The APB expects to publish such statements in relation to a range of entities (including specialised audits currently addressed by APB Practice Notes). These descriptions are likely to be based on existing APB material and, because APB does not participate in the auditing profession's risk management activities, will not contain the "Bannerman disclaimer". The APB recognises that given their responses to "The Auditor's Report: A time for change?" many audit firms will wish to continue to include this disclaimer in their auditor's report.

Bulletin providing illustrative auditor's reports for accounting periods commencing on or after 6 April 2008 but ending before 6 April 2009

- 3.19 In their responses to "The Auditor's Report: A time for change?" a number of auditing firms and accountancy bodies emphasised the importance of APB issuing guidance, as a matter of urgency on reports under CA 2006 for "short accounting periods". To assist the firms the APB will issue a Bulletin containing a number of examples. Because auditor's reports on short accounting periods will need to comply with the existing ISA (UK and Ireland) 700 (and because ISA (UK and Ireland) 700 Revised will not be finalised until spring 2009) the examples in the Bulletin will reflect relatively minor modifications to the current auditor's report and do not reflect the "streamlining" planned for 2009¹³.

¹³ The examples will be based on the example provided in "The Auditor's Report: A time for change?" on pages 19 to 21

Initiate research to better understand what can realistically be done to make auditor's report more informative.

- 3.20 Responses from institutional investors supported a reduction in the current content of the auditor's report which they viewed as being designed primarily to minimise prospective liability but also called for reports to be made more informative. This view was not supported by audit firms or organisations representing preparers. Because of this difference in views the APB intends to explore this issue further both with UK stakeholders and internationally with a view to contributing to future changes to international auditing standards.
- 3.21 In particular more work is needed to establish whether there is consensus as to what sort of additional information would be of assistance to investors and then to explore the feasibility of it being provided.
- 3.22 Examples of additional information needs provided to APB to date include:
- (a) auditors highlighting the aspects of the financial statements, that although disclosed within the financial statements, are of particular importance to investors;
 - (b) auditors reporting important risks and uncertainties that they are aware of that may be, or may not, be disclosed in the annual report. For example the Business Review to be included in the Directors Report requires disclosure of the principal risks and uncertainties facing the company¹⁴;
 - (c) information on the main issues that the auditors discussed with the audit committee during the finalisation of the audit; and
 - (d) information to explain the main judgments made by the auditors during the audit.

These examples differ both in terms of the information to be provided and the nature and extent of the difficulties in auditors providing such information.

- 3.23 There are also other FRC initiatives which may impact this issue, including work to explore the complexity and relevance of the requirements relating to corporate reports.
- 3.24 The APB will explore this issue further and participate in international initiatives with a view to contributing to future changes to international auditing standards. Issues to be considered include:
- To what extent have developments in in company law / accounting standards¹⁵ provided the information that UK investor groups were seeking in auditor's reports?
 - To what extent will reports from audit committees provide such information?
 - What are the current expectations of users regarding the auditor's responsibilities in relation other information in the annual report (eg the Business Review included in the Directors Report)?

¹⁴ CA 2006 Section 417

¹⁵ In particular paragraphs 122 and 125 of IAS 1 on disclosures of key accounting policies and judgments and estimation uncertainties.

RESPONDENTS TO “THE AUDITOR’S REPORT: A TIME FOR CHANGE?”

Institutional investors

- 1) Association of British Insurers
- 2) Hermes
- 3) Investment Management Association

Organisations representing preparers of financial statements

- 4) Confederation of British Industry (CBI)
- 5) One Hundred Group of Finance Directors
- 6) Quoted Companies Alliance (QCA)

Auditing firms and accountancy bodies

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

Public sector bodies

- 23) Audit Commission
- 24) Audit Scotland
- 25) National Audit Office
- 26) Wales Audit Office

Private individuals

- 27) Duncan Alexander
- 28) PL Bunting
- 29) Mrs Margaret R Downes
- 30) Dr. Andrew Higson, Loughborough University
- 31) Harry Wilkinson

In addition an open meeting was held on 26 March 2008 to obtain views of stakeholders. The APB has had regard of views expressed at that meeting even where participants did not respond in writing to the APB.

EXTRACTS FROM THE CLARITY VERSION OF ISA 700¹⁶***Auditor's Report for Audits Conducted in Accordance with Both International Standards on Auditing and Auditing Standards of a Specific Jurisdiction or Country***

- 40 When the auditor has complied with both International Standards on Auditing and the auditing standards of a specific jurisdiction or country (for purposes of this ISA referred to as “the national auditing standards”) in the conduct of the audit, the auditor’s report shall refer to International Standards on Auditing in addition to the national auditing standards only if:
- (a) There is no conflict between the reporting requirements regarding the auditor’s report in International Standards on Auditing and those in the national auditing standards that affects the auditor’s opinion or the need to include an Emphasis of Matters paragraph in the particular circumstances; and
 - (b) The auditor’s report includes, at a minimum, each of the following elements when the auditor uses the layout or wording specified by the national auditing standards:
 - (i) A title;
 - (ii) An addressee, as required by the circumstances of the engagement;
 - (iii) An introductory paragraph that identifies the financial statements audited;
 - (iv) A description of management’s responsibility for preparing and presenting the financial statements;
 - (v) A description of the auditor’s responsibility to express an opinion on the financial statements and the scope of the audit, that includes:
 - A reference to International Standards on Auditing and the national auditing standards; and
 - A description of the work an auditor performs in an audit;
 - (vi) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the country of origin of the financial reporting framework that is not International Financial Reporting Standards or International Public Sector Accounting Standards);
 - (vii) The auditor’s signature;
 - (viii) The date of the auditor’s report; and
 - (ix) The auditor’s address.
41. When the auditor’s report refers to both International Standards on Auditing and the national auditing standards, the auditor’s report shall identify the

¹⁶ These extracts are from the IAASB’s Exposure Draft of the Clarity version of ISA 700. The APB expects these paragraphs to be promulgated by the IAASB, in substance, in the final version of ISA 700 (Redrafted).

jurisdiction or country of origin of the national auditing standards.

Auditor's Report Prescribed by Law or Regulation

42. When the audit is conducted in accordance with International Standards on Auditing and the auditor is required by law or regulation to use a specific layout or wording of the auditor's report, the auditor's report shall refer to International Standards on Auditing only if the conditions in paragraph 40 are met (with references to national standards in paragraph 40 being read as references to the relevant law or regulation, where appropriate), and the auditor's report shall thereby identify such law or regulation.