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Analysis of the main potential changes in auditing standards arising from the Exposure Draft of ISA 720 (Revised)

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Analysis of the main potential changes in auditing standards arising from the Exposure Draft of ISA 720 (Revised) "The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon" issued by the IAASB in November 2012

This paper has been prepared to assist those seeking to understand the implications of the proposals in the IAASB's exposure draft of ISA 720 (Revised).

The FRC would welcome comments from interested parties on the exposure draft by 15 February 2013, before it finalises its response to the IAASB. Comments, preferably in an electronic form that facilitates "copy and paste", may be sent by e-mail to k.billing@frc.org.uk. If this is not possible, please send written comment to:

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Interested parties are also encouraged to comment on the exposure draft direct to the IAASB before its comment deadline of 14 March 2013.

- 1. The current International Standard on Auditing (ISA) 720, "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements" issued by the International Auditing and Assurance Standards Board (IAASB), is used as the basis for the FRC's ISA (UK and Ireland) 720 Section A which has the same title.
- 2. The IAASB is proposing to revise ISA 720 to reflect that there have been a number of developments in the corporate reporting environment that have led to significant changes in the nature and extent of information included in documents containing audited financial statements and the auditor's report thereon. These developments include:
 - Annual reports generally include more narrative and qualitative information, such as descriptions of the entity's business model, risk exposures and uncertainties, than in the past.
 - Movements towards exploring ways to better integrate information in the different parts of an entity's public reporting package.
 - Changes in the manner in which annual reports are distributed, increasingly by electronic means.
 - Some entities are making increasing and more divergent use of documents other than the annual report for their external communication purposes in connection with the issuance of their audited financial statements i.e. presenting relevant information in documents accompanying the audited financial statements, instead in in documents containing the audited financial statements.
- 3. Responding to these developments, the IAASB's proposals will introduce significant changes, including:

- Extending the scope of the standard to include documents accompanying audited financial statements and the auditor's report thereon;
- Extending the auditor's responsibilities (i.e., the work effort) to include not only reading the other information for consistency with the audited financial statements but also reading and considering the other information for consistency with the auditor's understanding of the entity and the environment acquired during the course of the audit; and
- Enhancing transparency of the auditor's work with respect to other information through new suggested auditor reporting responsibilities - requiring auditors to articulate in their reports their responsibilities under the proposed ISA, and the outcome of their work relating to the other information.
- 4. Copies of the IAASB's exposure draft can be downloaded free of charge from the IAASB's website¹. The exposure draft includes an Explanatory Memorandum that provides further background to, and an explanation of, the proposed revision. Significant matters discussed include:

Scope of the proposed ISA

The IAASB has identified that in some jurisdictions, entities may distribute along with the audited financial statements additional documents (such as the Chairman's Statement, management reports or statements on corporate governance, internal control and risk assessment), whether required by law or regulation, to explain, among other things, the audited financial statements or the financial reporting process. The IAASB has decided that an accompanying document would be in scope of the standard if it has a primary purpose of providing commentary to enhance the users' understanding of the audited financial statements or the financial reporting process, as such a document would be directly related to the purpose of the financial statement audit. Examples are given in the standard of accompanying documents that would be within or outside the scope.

Objectives

The proposed revised ISA introduces revised objectives for the auditor, having read and considered the other information, to:

- (a) Respond appropriately when, in light of the auditor's understanding of the entity and its environment acquired during the course of the audit, the auditor identifies that:
 - (i) There may be a material inconsistency in the other information; or
 - (ii) The audited financial statements may be materially misstated; and
- (b) Report in accordance with the proposed revised ISA

Definition of an inconsistency in other information

The IAASB has proposed a definition of an inconsistency in the other information that specifies that such an inconsistency would exist when the other information:

- (a) Contains information that is incorrect, unreasonable or inappropriate; or
- (b) Is presented in a way that omits or obscures information that is necessary to understand properly the matter being addressed in the other information

The IAASB has further explained in the proposed revised ISA when it would consider an inconsistency in the other information to be *material*, that is, if the inconsistency

www.ifac.org/publications-resources/international-standard-auditing-isa-720-revised-auditor-s-responsibilities-re

could reasonably be expected to influence the economic decisions of the users for whom the auditor's report is prepared *taken on the basis of the audited financial statements and the other information as a whole.*

Nature and extent of work effort for considering the other information

The IAASB has adopted a principles-based approach in the proposed revised ISA by way of the requirement that the auditor shall read and consider the other information in light of the auditor's understanding of the entity and its environment acquired during the course of the audit, that is supported by detailed guidance to inform the auditor's judgment regarding the nature and extent of the work effort. The IAASB believes this will drive auditors to make judgments about, and tailor their work effort in response to, the different situations. There are further requirements if the auditor identifies that there may be a material inconsistency in the other information.

Responding when the auditor identifies that the audited financial statements may be materially misstated

In the proposed revised ISA, the actions the auditor may take in these circumstances will depend upon whether the other information was obtained prior to, or after, the date of the auditor's report.

In the former case, the new information may have implications for the auditor's risk assessment, which may require revision in accordance with ISA 315 with consequential implications for the auditor's planned procedures.

In the latter case, the new information may reveal a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. In that case, the auditor would need to address this situation in accordance with the auditor's responsibilities under ISA 560, "Subsequent Events". The proposed revised ISA 720 provides guidance in this regard. However, circumstance where the other information is obtained after the date of the auditor's report currently does not arise in the UK and Ireland because ISA (UK and Ireland) 700, "The Auditor's Report on Financial Statements", requires that "The auditor shall not sign, and hence date, the report earlier than the date on which all other information contained in a report of which the audited financial statements form a part have been approved by those charged with governance and the auditor has considered all necessary available evidence."

Reporting

Feedback received from respondents to the IAASB's May 2011 Auditor Reporting Consultation Paper indicated a need for greater transparency about the work the auditor undertakes regarding the other information. In addition to requiring a description of the auditor's responsibilities with respect to the other information in the auditor's report, the proposed ISA requires identification of the *specific documents* the auditor has read and considered, and whether, based on reading and considering the other information, the auditor has identified material inconsistencies in the other information. Further, to make it clear that the auditor has not audited or reviewed the other information and accordingly does not express an audit opinion or a review conclusion on it, the proposed ISA requires inclusion of a statement to that effect in the auditor's report.

5. The IAASB asks a number of specific questions of commentators, which are reproduced in Attachment 1 to this paper.

Comparison to ISA (UK and Ireland) 720 Section A – Revised October 2012

- 6. At the end of September 2012, the FRC issued a revision of ISA (UK and Ireland) 720 Section A, based on the current ISA 720, to implement proposals from the FRC's Effective Company Stewardship project, effective for audits of financial statements for periods commencing on or after 1 October 2012. Attachment 2 to this paper sets out a table that is intended to help facilitate a comparison of the corresponding text of the objectives, definitions and requirements in the IAASB exposure draft and ISA (UK and Ireland) 720 Section A as revised for October 2012.
- 7. It can be seen from Attachment 2 that the FRC anticipated in substance some of the changes being proposed by the IAASB. In particular, the requirement for the auditor to not only read the other information for consistency with the audited financial statements but also read and consider the other information for consistency with the auditor's understanding of the entity and its environment acquired during the course of the audit (the ISA (UK and Ireland) refers to consistency with the auditor's 'knowledge' acquired during the course of the audit).

IAASB request for specific comments

The Explanatory Memorandum in the IAASB's exposure draft (which is available from the link in footnote 1) sets out requests for specific comments on significant matters. These are reproduced below. The Explanatory Memorandum provides a detailed explanation of the changes that are being proposed, which underlie these requests for comments.

Scope of the proposed ISA

- 1. Do respondents agree that there is a need to strengthen the auditor's responsibilities with respect to other information? In particular do respondents believe that extending the auditor's responsibilities with respect to the other information reflects costs and benefits appropriately and is in the public interest?
- 2. Do respondents agree that broadening the scope of the proposed ISA to include documents that accompany the audited financial statements and the auditor's report thereon is appropriate?
- 3. Do respondents find the concept of initial release clear and understandable? In particular, is it clear that initial release may be different from the date the financial statements are issued as defined in ISA 560?
- 4. Do respondents agree that the limited circumstances in which a securities offering document would be in scope (e.g., initial release of the audited financial statements in an initial public offering) are appropriate or should securities offering documents simply be scoped out? If other information in a securities offering document is scoped into the requirements of the proposed ISA in these circumstances, would this be duplicating or conflicting with procedures the auditor may otherwise be required to perform pursuant to national requirements?

Objectives

- 5. Do respondents consider that the objectives of the proposed ISA are appropriate and clear? In particular:
 - (a) Do respondents believe that the phrase "in light of the auditor's understanding of the entity and its environment acquired during the audit" is understandable for the auditor? In particular, do the requirements and guidance in the proposed ISA help the auditor to understand what it means to read and consider in light of the auditor's understanding of the entity and its environment acquired during the course of the audit?
 - (b) Do respondents believe it is clear that the auditor's responsibilities include reading and considering the other information for consistency with the audited financial statements?

Definition of an inconsistency in the other information

- 6. Do respondents agree that the definitions of terms of "inconsistency" including the concept of omissions and "a material inconsistency in the other information are appropriate?
- 7. Do respondents believe that users of auditors' reports will understand that an inconsistency relates to an inaccuracy in the other information as described in (a) and (b) of the definition, based on reading and considering the other information in light of the auditor's understanding of the entity and its environment acquired during the course of the audit?

Nature and extent of work effort

- 8. Do respondents agree with the approach taken in the proposed ISA regarding the nature and extent of the auditor's work with respect to the other information? In particular:
 - (a) Do respondents believe the principles-based approach for determining the extent of work the auditor is expected to undertake when reading and considering the other information is appropriate?
 - (b) Do respondents believe the categories of other information in paragraph A37 and the guidance for the nature and extent of the work effort for each category are appropriate?
 - (c) Do respondents agree that the work effort is at the expected level and does not extend the scope of the audit beyond that necessary for the auditor to express an opinion on the financial statements?
- 9. Do respondents believe that the examples of qualitative and quantitative information included in the Appendix in the proposed ISA are helpful?

Responding when the auditor identifies that the audited financial statements may be materially misstated

10. Do respondents believe it is clear in the proposed requirements what the auditor's response should be if the auditor discovers that the auditor's prior understanding of the entity and its environment acquired during the audit was incorrect or incomplete?

Reporting

- 11. With respect to reporting:
 - (a) Do respondents believe that the terminology (in particular, "read and consider," "in light of our understanding of the entity and its environment acquired during our audit," and "material inconsistencies") used in the statement to be included in the auditor's report under the proposed ISA is clear and understandable for users of the auditor's report?
 - (b) Do respondents believe it is clear that the conclusion that states "no audit opinion or review conclusion" properly conveys that there is no assurance being expressed with respect to the other information?
- 12. Do respondents believe that the level of assurance being provided with respect to other information is appropriate? If not, what type of engagement would provide such assurance?

Comparison of the objectives, definitions and requirements in the IAASB exposure draft to ISA (UK and Ireland) 720 Section A as revised for October 2012.

To help understand the significant detailed differences between the exposure draft and ISA (UK and Ireland) 720 Section A as revised for October 2012, the staff of the FRC have prepared the table below to facilitate comparison of the text in the corresponding sections covering the objectives, definitions and requirements. ISA (UK and Ireland) 720 Section A adopts the text of the current ISA 720, with supplementary wording added by the FRC which is differentiated by the use of grey shading.

The proposed revised ISA also includes a significant amount of new application and other explanatory material which is not reproduced below.

ED ISA 720 (Revised) – November 2012				(UK and Ireland) 720 Section A – Revised ober 2012
Ob	Objectives			
8.		objectives of the auditor, having read considered the other information, are to: Respond appropriately when, in light of the auditor's understanding of the entity and its environment acquired during the course of the audit, the auditor identifies that: (i) There may be a material inconsistency in the other information; or (ii) The audited financial statements may be materially misstated; and Report in accordance with this ISA.	4.	The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report.
Definitions				
9.		purposes of the ISAs, the following as have the meanings attributed below: Inconsistency in the other information – An inconsistency in the other information exists when the other information: (i) Contains information that is incorrect, unreasonable or inappropriate; or (ii) Is presented in a way that omits or obscures information that is necessary to properly understand the matter being addressed in the other information. An inconsistency in the other information is material if it could reasonably be expected to influence the economic decisions of the users for whom the auditor's report is prepared	5.	For purposes of the ISAs (UK and Ireland) the following terms have the meanings attributed below: (b) Inconsistency – Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements. (c) Misstatement of fact – Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited

ED ISA 7	20 (Revised) – November 2012		UK and Ireland) 720 Section A – Revised ber 2012
	taken on the basis of the audited financial statements and the other information as a whole.		financial statements. In the context of an audit conducted in accordance with ISAs (UK and Ireland), other information that is incorrectly stated or presented includes other information that is apparently incorrect based on, or inconsistent with, the knowledge acquired by the auditor in the course of performing the audit or that is otherwise misleading.
	Initial release —Initial release occurs when the audited financial statements and the auditor's report thereon for a reporting period are first made generally available to the group of users for whom the auditor's report is prepared, often the shareholders.	-	
	Other information –Financial and non- financial information (other than audited financial statements and the auditor's report thereon) included in a document that is issued by the entity in connection with the initial release, and that: (i) Contains the audited financial statements and the auditor's report thereon; or (ii) Accompanies the audited financial statements and the auditor's report thereon and has a primary purpose of providing commentary to enhance the users' understanding of the audited financial statements or the		(a) Other information – Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.
	financial reporting process.		
Requirer	nents		
Obtainin	g the Other Information		
(a) (b)	auditor shall: Discuss with management the nature and timing of the documents that are expected to be issued in connection with the initial release and determine which of them are within the scope of this ISA; and Make appropriate arrangements with management to obtain in a timely manner, and if possible prior to the date of the auditor's report, the final version of the documents that are within the		The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. If it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable ^{1a} .

¹a ISA (UK and Ireland) 700 requires that "The auditor shall not sign, and hence date, the report earlier than the date on which all other information contained in a report of which the audited financial statements form a part have been approved by those charged with governance and the auditor has considered all necessary available evidence."

ED ISA 720 (Revised) – November 2012		ISA (UK and Ireland) 720 Section A – Revised October 2012	
	scope of this ISA.		
	ding and Considering the Other rmation		
11.	The auditor shall read and consider the other information in light of the auditor's understanding of the entity and its environment acquired during the course of	 6. The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements. 6-1. The auditor shall also read the other 	
	the audit.	information to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit.	
The	ponding When the Auditor Identifies That re May Be a Material Inconsistency in the er Information		
12.	If, based on reading and considering the other information, the auditor identifies that there may be a material inconsistency in the other information, the auditor shall discuss the matter with management and, if	8. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.	
	necessary, perform other procedures to determine whether a material inconsistency in the other information does exist.	14. If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management.	
		14-1. If, on reading the other information for the purpose of identifying any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit, the auditor becomes aware of an apparent misstatement of fact, the auditor shall discuss the matter with management.	
13.	If the auditor determines that a material inconsistency in the other information does exist, the auditor shall request management to correct the other information. If management:	10. If revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance, unless all of those	
	 (a) Agrees to make the correction, the auditor shall determine that the correction has been made; or (b) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be 	charged with governance are involved in managing the entity; ² and 15. If, following such discussions [required by paragraphs 14 and 14-1], the auditor still considers that there is an apparent material misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's	

2 ISA (UK and Ireland) 260, "Communication with Those Charged with Governance," paragraph 13.

ED ISA 720 (Revised) – November 2012	ISA (UK and Ireland) 720 Section A – Revised October 2012	
 14. If the other information is not corrected after communicating with those charged with governance, the auditor shall: (a) When the other information was obtained prior to the date of the auditor's report, take appropriate action, including: (i) Considering the reporting implications (see paragraph 16(c)); or (ii) Withdrawing from the engagement, where withdrawal is possible under the applicable law or regulation; or 	legal counsel, and the auditor shall consider the advice received. 16. If the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall notify those charged with governance, unless all of those charged with governance are involved in managing the entity, of the auditor's concern regarding the other information and take any further appropriate action. (a) Include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with ISA (UK and Ireland) 706; ³ or (b) Withhold the auditor's report; or (c) Withdraw from the engagements, where withdrawal is possible under applicable law or regulation.	
(b) When the other information was obtained after the date of the auditor's report, take appropriate action in accordance with ISA 560, taking into account the auditor's legal rights and obligations.	The FRC standard explains that the IAASB ISA requirements in relation to information obtained after the date of the auditor's report are not applicable in an audit conducted in accordance with ISAs (UK and Ireland) because ISA (UK and Ireland) 700, "The Auditor's Report on Financial Statements" requires that "The auditor shall not sign, and hence date, the report earlier than the date on which all other information contained in a report of which the audited financial statements forma part have been approved by those charged with governance and the auditor has considered all necessary available evidence."	
Responding When the Auditor Identifies That the Audited Financial Statements May Be Materially Misstated		
15. If, based on reading and considering the other information, the auditor identifies information that indicates that the audited financial statements may be materially misstated, the auditor shall perform procedures necessary under the ISAs to	9. If revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in the auditor's report in accordance with ISA (UK and Ireland) 705.	

 ISA (UK and Ireland) 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report," paragraph 8.
 In the UK and Ireland those charged with governance are responsible for the preparation of the financial statements. 3

ED	ISA 720 (Revised) – November 201	ISA (UK and Ireland) 720 Section A – Revised October 2012
	determine whether the audited final statements are materially misstated	
Rep	porting	
	Where the auditor has obtained the information prior to the date of the a report, the auditor shall include a st in the auditor's report comprising the following elements: (a) A description of the auditor's responsibilities with respect to information; (b) Identification of the specific do that contain the other information the auditor has read and consi part of the audit of the financial statements; (c) A statement addressing wheth on reading and considering the information obtained, the audit identified material inconsistent other information, and, if so, a statement describing them; and (d) A statement that the auditor has audited or reviewed the other information and accordingly do express an audit opinion or a reconclusion on it.	attement the scope of an audit to include "In addition, we read all the financial and non-financial information in the [describe the annual report] to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report." Paragraph 22A requires, "In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code or to explain why they have not, the auditor shall report by exception if, when reading the other financial and non-financial information included in the annual report, the auditor has identified information in the audited financial statements or is apparently
17.	When the auditor's opinion on the fi statements is modified, the auditor consider the implications of the mod for the statement required in paragrant 16(c).	shall dification
Rep	porting Prescribed by Law or Regulat	ion
18.	If the auditor is required by law or re of a specific jurisdiction to report wirespect to the other information and specific layout or wording in the auditor's shall refer to International Standard Auditing only if the auditor's report is at a minimum: (a) A description of the auditor's responsibilities with respect to information; (b) Identification of the documents containing the other information auditor has read and considered.	the auditor's report refers to compliance with ISAs (UK and Ireland). However, ISA (UK and Ireland) 700 has been designed to ensure that compliance with it will not preclude the auditor currently from being able to assert compliance with the ISAs issued by the IAASB. The possible need for conforming changes to this standard will be considered in due course.]

ED ISA 720 (Revised) – November 2012	ISA (UK and Ireland) 720 Section A – Revised October 2012
(c) An explicit statement addressing the outcome of the auditor's work for this purpose.	
Documentation	
When the auditor has identified a material inconsistency in the other information, the auditor shall include in the audit documentation how the auditor has addressed the inconsistency.	[There are no specific documentation requirements in the current ISA (UK and Ireland).]
20. The auditor shall retain in the audit documentation the document(s) on which the auditor has performed the work required under this ISA.	



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