Financial Reporting Council

June 2013

Feedback Statement on consultation on proposed revision to ISA (UK and Ireland) 700

requiring the auditor's report to address risks of material misstatement, materiality and a summary of the audit scope

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

FEEDBACK STATEMENT ON CONSULTATION ON PROPOSED REVISION TO ISA (UK AND IRELAND) 700 REQUIRING THE AUDITOR'S REPORT TO: ADDRESS RISKS OF MATERIAL MISSTATEMENT, MATERIALITY AND A SUMMARY OF THE AUDIT SCOPE.

Introduction

1.1 In February 2013, the FRC issued a Consultation Paper proposing changes to ISA (UK and Ireland) 700.

1.2 In overview the changes proposed to require the auditor's report to:

- Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.
- Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; and
- Provide a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement and the auditor's application of the concept of materiality, as disclosed in the auditor's report.

1.3 These new requirements would only apply to those entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code.

1.4 The proposed changes need to be seen in the context of changes that were made to ISA (UK and Ireland) 700 in October 2012. These changes (which were made in conjunction with changes to the UK Corporate Governance Code) were mainly directed at:

- Enhancing auditor communication by requiring the auditor to communicate to the audit committee:
  - (i) information relevant to the board (and if applicable the audit committee) in fulfilling its responsibility for making the statement that the annual report is fair, balanced and understandable and for reviewing the effectiveness of the company's risk management and internal control systems;
  - (ii) information that the auditor believes the audit committee will need to understand the significant professional judgments made in the course of the audit and in reaching their audit opinion and the auditor's insights about the entity's internal control system based on their audit work; and
- Extending auditor reporting by requiring the auditor to report, by exception, if the board's statement that the annual report and accounts taken as a whole is fair balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of performing the audit, or if the matters disclosed in the report from the audit committee do not appropriately address matters communicated by the auditor to the committee.

1.5 Based on an extensive outreach programme undertaken in 2012 the FRC concluded that the changes to ISA (UK and Ireland) 700 that it made in October 2012 may not provide all of the outcomes that it originally envisaged. Specifically:

- The auditor's report under the October 2012 changes would, unless the directors failed to fulfil their reporting responsibilities properly, consist largely of standardised language. The FRC was concerned that as standardised language has less communicative value that it provides less incentive for stakeholders to read and engage with the report than more company specific information would;
- Although, the October 2012 changes to the ISAs (UK and Ireland) would provide information to stakeholders with regard to the outcome of the audit, stakeholders would also derive considerable benefit from being provided with the information that was the subject of the February 2013 consultation; and
- As such information is typically communicated to the audit committee by the auditor it could be disclosed in the annual report under the changes to the UK Corporate Code made in September 2012, as important judgments the audit committee considered in carrying out its work. However, as such information falls more naturally in the auditor's domain it would be more appropriate for such information to be disclosed by the auditor in the auditor's report.

1.6 The proposed effective date was for periods commencing on or after 1 October 2012. This was because the effective date would be the same as that for the October 2012 changes to ISA (UK and Ireland) 700.

1.7 The Consultation Paper included an illustration of the proposed disclosures. The Paper explained that this was one possible interpretation of an auditor's response to the proposed changes that may provoke other views on how the proposed requirements should be interpreted. The Paper explained that it is not intended that such illustrative text would be included in the examples in the FRC's compendia audit report Bulletins. Rather, and in order to avoid encouraging the use of standardised text, those examples would include a square bracketed comment to the effect that the auditor should include a description of the matters required by ISA (UK and Ireland) 700.

Outreach activities

Public meeting

2.1 In March 2013 the FRC held a public meeting to discuss the proposals in the Consultation Paper, which was attended by approximately 65 members of the public. Participants at the public meeting, on the whole, expressed support for the FRC's proposals. However, a number of recommendations were made with respect to the detail of the proposals. A synopsis of the Public Meeting can be found at: http://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Consultation-Paper-Revision-to-ISA-(UK-and-Ireland.aspx

Informal outreach with US investor groups

2.2 We held informal outreach meetings with 8 major US investor groups that make investments in the UK. All but one of these groups was extremely supportive of the proposals and one of them has submitted a formal response.

<u>Formal responses to the Consultation</u>

3.1 31 responses to the Consultation were received from the following stakeholder groups

• Investors	11
• Audit Firms	11
• Accounting Institutes	4
• Preparers of financial statements	1
• Public Sector	1
• Other organisations	3
	31

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

3.2 There is a wide diversity of responses which we have categorised as follows:

• Agree with proposals	9
• Agree with thrust of proposals but suggest improvements	10
• Agree that the proposed disclosures should be made but by the audit committee rather than in the audit report	2
• Broadly agree with the proposal but do not support the FRC moving in advance of the IAASB	5
• Disagree with proposals	5
	31

3.3 Based on its analysis of the responses, in conjunction with the comments heard at the Public Meeting, the FRC is of the view that:

- The majority of respondents are on balance supportive of its proposals;
- Some of the comments of less supportive respondents had been considered and rejected by the FRC prior to Consultation; and
- Many comments of other less supportive commentators often seem to reflect a misunderstanding on the part of the commentator of the relationship of the February 2013 proposals to the changes made to ISA (UK and Ireland) 700 in October 2012.
- Only very few commentators oppose the proposals outright.

3.4 In relation to the respondents who fall in the last three categories described in paragraph 3.2 the FRC would comment as follows.

Prefer disclosure of the information by the audit committee

3.5 With respect to the two commentators who support disclosure of the information by the audit committee rather than the auditor (1 investor and the British Private Equity and Venture Capital Association). The FRC explained in the Consultation Paper[1] why it believed that this information was in the domain of the auditor and the risk that directors may not be comfortable in discussing details of the audit in their report.

[1] See paragraphs 11 to 13 of Consultation Paper.

3.6 The FRC takes the view that these commentators have not countered these arguments and that many other respondents generally supported and welcomed the inclusion of these matters in the auditor's report.

Moving in advance of IAASB

3.7 With respect to the five commentators that do not support the FRC moving in advance of the IAASB (3 audit firms, 1 Accounting Institute and the NAO), the FRC continues to take the view that it should move now and not wait for developments at the IAASB. This approach is consistent with the October 2012 changes to ISA (UK and Ireland) which also moved in advance of the IAASB. The IAASB has to date issued an "Invitation to Comment" only and will not have firm proposals to expose for comment until June 2013 at the earliest. It is uncertain what its timetable for implementing any finally agreed changes will be.

3.8 The FRC believes that there is an expectation amongst users that it will "complete the circle" by implementing this element of the requirements alongside the requirements introduced for reporting about the work of the audit committee in October 2012. The FRC intends to continue to monitor and seek to influence developments in the IAASB's project.

Disagreement with the proposals

3.9 3 of the 5 commentators who disagree with the proposals are audit firms (2 smaller and 1 mid-tier), 1 is an Accounting Institute (Irish) and 1 is an academic. The arguments made by the audit firms are broadly that though investors want this information, there are risks to auditors in providing it, it won't necessarily help investors and it will cause divergence with international standards – one further argues that (in their view) there are significant risks for audit firms and that the proposals are unhelpful in the context of trying to promote increased competition for the audits of larger listed entities.

3.10 The Accounting Institute expresses the opinion that FRC should not move to implement these proposals as they stand but needs to consider giving clearer definitions of the additional information to be provided in the auditor's report and provide more application guidance to support relevant and effective implementation. In general, as auditor's are intended to use their judgment, the FRC is reluctant to make the application material overly rules based.

3.11 The academic commentator believes that the information will neither help investors nor provide a basis for engagement as proposed. In principle, this commentator rejects the notion of disclosing lists of risks either by the directors or auditors. This commentator suggests innovative alternative matters for disclosure that it considers would be more helpful. As these disclosures are information about the entity's financial information in the FRC's overall scheme of reporting they would be better dealt with through the audit committee channel.

<u>Addressing detailed recommendations for improvement of the proposals</u>

4.1 The Consultation Paper posed a number of questions and the following are the more significant points that have been addressed in finalising the wording of ISA (UK and Ireland) 700.

Term "audit scope"

4.2 The use of the term "audit scope" in proposed paragraph 16A(c) led to confusion on the part of a small number of commentators with the generic description of the "scope of an audit of financial statements" referred to in paragraph 16 and maintained on the FRC's web-site.

4.3 We addressed this issue by:

- Changing the heading to paragraph 16 to be "Description of the Generic Scope of an Audit";
- Including similar wording in the run-in to paragraph 16;
- Added a new heading to what is now paragraph 19A of "Entities that Report on Application of the UK Corporate Governance Code";
- Amended the wording in what is now paragraph 19A(c) to "Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement…".

Risk that report will be seen as expressing a piece meal opinion

4.4 A number of commentators were concerned that it should be made clear that the auditor's report should not be seen as providing piecemeal opinions about individual elements of the financial statements discussed in the report, especially those addressed in describing the risks of material misstatement. To address this, these commentators recommended that:

- more application material on the type of information that may be provided with each key risk is provided; and
- language is included in the auditor's report that clarifies that the auditor's response to the key risks is designed in the context of the financial statements as a whole (in line with IAASB thinking).

4.5 With respect to the first suggestion, the FRC is reluctant to make the application material overly rules based. Auditors are intended to use their judgment. In response to the second suggestion new paragraph 19B has been inserted. It states "In order to be useful to users of the financial statements, the explanations of the matters required to be set out in the auditor's report by paragraph 19A shall be described:

- So as to enable a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements.
- In a way that enables them to be related directly to the specific circumstances of the audited entity and are not, therefore, generic or abstract matters expressed in standardised language.
- In a manner that complements the description of significant issues relating to the financial statements, required to be set out in the separate section of the annual

report describing the work of the audit committee in discharging its responsibilities. The auditor seeks to coordinate descriptions of overlapping topics addressed in these communications, to avoid duplication of reporting about them, whilst having appropriate regard to the separate responsibilities of the auditor and the board for directly communicating information primarily in their respective domains".

Undue focus on group audit situation

4.6 A number of commentators expressed the view that proposed explanatory paragraph A9C was overly focused on the scope of audit of groups and that this paragraph should be more balanced as between group and non-group situations. In particular, a number of commentators questioned the emphasis on the interaction with component auditors. A concern was also expressed by some that the proposals may give the mistaken impression that the group auditor is not solely responsible for the opinion on the group financial statements.

4.7 The structure of this paragraph (which is now A13C) has been improved so as to be more balanced as between group and non-group situations.

Threshold for the disclosure of identified risks

4.8 Some respondents questioned whether the definition of the threshold for the disclosure of identified risks should be aligned with the ISAs definition of "significant risk" but most concurred with the FRC proposal as being appropriate. Some of those who wanted an alignment further suggested that if the FRC decides not to so align the definitions the FRC should indicate when it might not be appropriate to report a risk that is not a significant risk, and when not to report a significant risk.

4.9 The FRC is of the view that adequate guidance in this respect was given in the proposed requirement "*Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team".* Further detailed guidance should not be necessary and will risk being overly rules based when the objective is for the auditor to apply its judgment. However, to seek to reinforce the FRC's position the following sentence has been included in paragraph A13A *"However, the auditor uses its judgment to determine which, if any, of the significant risks and which, if any, of the other identified risks meet the criteria set out in paragraph 19A(a) and are to be described in the auditor's report."*

Overly complex description of materiality

4.10 A number of commentators, in particular auditors, expressed concern about the complexity of the description of materiality in the illustrative disclosures in the Consultation Paper. For example, one commentator stated "We are of the opinion that the additional reporting requirement and the illustrative disclosures on materiality in Section 3 as currently proposed may be too complex for users of the financial statements. In particular, we would recommend that performance materiality should not be disclosed as this may lead to additional confusion".

4.11 A number of these commentators seemed not to have recognised that the only quantitative disclosure required to be given as part of the explanation of materiality was "the threshold used by the auditor as being materiality for the financial statements as a whole". Paragraph A13B being "Application and other explanatory material" does not stipulate requirements. In addition, it is for the auditor to ensure that the description of how the concept of materiality has been applied is communicated in a manner that is readily understandable by users who may not understand the technical terms used in the ISAs (UK and Ireland).

4.12 However, two changes have been made to what is now paragraph A13B. There is clarification that the explanation is tailored "to the particular circumstances <u>and complexity</u> of the audit. In addition, the words "for example" are included immediately before the list of bullet points to seek to clarify that the bulleted list is not a list of requirements.

Need for clarification that the auditor's report should explain how the assessed risks of material misstatement were addressed

4.13 One respondent suggested that the auditor's report should explain how the assessed risks of material misstatement were addressed in the audit. This was in fact the FRC's intended purpose of the requirement which is now in paragraph 19A to provide "a summary of the audit scope, <u>including an explanation of how the scope was responsive to the assessed risks of material misstatement</u>".

4.14 In view of this comment, which suggests this may need to be made clearer, the drafting of both paragraphs 19A and A13C has been revised to explicitly state that the auditor shall "Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement…".

Need for clarification as to the key principles underlying which information should be included in the auditor's report

4.15 Some commentators suggested that there is a need for ISA (UK and Ireland) 700 to clarify the key principles underlying any additional information to be provided by auditors in the auditor's report and how the information included in the auditor's report is intended to relate to the report issued by the audit committee.

4.16 The FRC believes that paragraphs 19A, 19B, 22A, 22B, A13A, A13B, A13C and A18A provide considerable guidance in this regard. Paragraph 19B further clarifies that there is scope for signposting and cross referencing, including to the audit committee report.

<u>Those that choose voluntarily to comply with the UK Corporate Governance Code</u>

5.1 Concerns have been expressed by some auditor commentators as to whether the proposals should apply to those who voluntarily choose to comply with the UK Corporate Governance Code. Such entities include, for example, companies that list on AIM and Industrial and Provident Societies. Those expressing the concerns contend that auditors and directors of such entities may not be as well equipped to deal with the new demands and that meeting these demands may not meet a cost benefit test. Some further contend that the proposals may deter voluntary compliance with the Code.

5.2 The Quoted Companies Alliance, however, expressed the view that restricting the revision to those companies that apply the UK Corporate Governance Code is a proportionate and reasonable response to demands from users for auditors to provide additional information in the auditor's report.

5.3 The FRC's view is that the approach taken in the Consultation Paper is consistent with that adopted for the October 2012 changes to ISAs (UK and Ireland) and that it would be inappropriate to adopt a different approach to these requirements which are intended to complement them.

Implementation timing

6.1 The Consultation Paper proposed an effective date of periods commencing on or after 1 October 2012. This would mean that the effective date would be the same as that for the October 2012 changes to ISA (UK and Ireland) 700. As the auditor is already required to disclose the information to be included in the audit report to the audit committee the work effort in preparing it and familiarising the audit committee with it should be minimal.

6.2 The majority of commentators do not foresee difficulty with meeting the proposed effective date for implementation of the proposals of periods commencing on or after 1 October 2012. However, a number of these commentators have indicated that their view is predicated on the basis that the final standard will be available by 30 June 2013 (this was the date indicated in the Consultation Paper).

6.3 One of the larger accounting firms and all three of the Accounting Institutes recommend that mandatory implementation be delayed. The accounting firm recommended that mandatory implementation be delayed until 31 December 2013 to "allow auditors sufficient time to consider the full implications of the changes for their audit reports". Another of the larger accounting firms commented that implementing the changes in conjunction with all the other changes coming into effect on the same date may be "a challenge".

6.4 One of the Institutes expresses the view that the extent of the changes, in the context of other changes being made by the FRC with the same effective date, is a "lot to ask". It suggests that if the FRC wants the proposals to be implemented properly it should postpone them for a year or stagger them. The alternative they suggest will be defensive reporting that complies with the letter rather than the spirit of the requirements.

6.5 Another of the Institutes suggests delaying implementation until the content of the IAASB's Exposure Draft becomes known. The third Institute suggests that the commencement date should not be earlier than a year from the date of issue of the revised ISA (UK and Ireland) 700.

6.6 The FRC has considered the comments made and decided to retain the original implementation date because it considers it to be important that these changes are implemented at the same time as the changes made in the October 2012 revision to ISA (UK and Ireland) 700. For the reasons set out in paragraph 6.1 above compliance with the revised ISA (UK and Ireland) 700 is not expected to be unduly onerous.

RESPONDENTS TO CONSULTATION

Investors

1. Association of British Insurers (ABI)
2. Chartered Financial Analysts Society (CFA)
3. Colorado Public Employees' Retirement Association
4. Mr Gavin Palmer
5. Hermes
6. Invesco Perpetual UK Equities
7. Investment Management Association
8. Legal & General
9. Local Authority Pension Plan Forum
10. National Association of Pension Funds (NAPF)
11. Standard Life

Auditing firms

12. Baker Tilly LLP
13. BDO LLP
14. Crowe Clark Whitehill LLP
15. Deloitte LLP
16. Ernst & Young LLP
17. Grant Thornton LLP
18. Kingston Smith LLP
19. KPMG LLP
20. Mazars LLP
21. PwC LLP
22. Reeves & Co LLP

Accounting Institutes

23. ACCA
24. Chartered Accountants Ireland
25. Institute of Chartered Accountants in England & Wales (ICAEW)
26. Institute of Chartered Accountants of Scotland (ICAS)

Financial Statement Preparers

27. Quoted Companies Alliance (QCA)

Public Sector

28. National Audit Office (NAO)

Other Organisations

29. British Private Equity and Venture Capital Association
30. Matthew Leitch Associates
31. Z-Yen Group

Copies of the comment letters are maintained on the FRC's web-site at http://frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Consultation-Paper-Revision-to-ISA-(UK-and-Ireland.aspx

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