



# Consultation Paper

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**Proposed revisions to International Standards on Auditing (UK and Ireland) to give effect to the FRC Effective Company Stewardship proposals:**

- 260** “Communication with those charged with governance”
- 265** “Communicating deficiencies in internal control to those charged with governance”
- 700** “The auditor’s report on financial statements” (*Revised*)
- 720A** “The auditor’s responsibilities relating to other information in documents containing audited financial statements”

April 2012

## **THE AUDITING PRACTICES BOARD**

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and the Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditor's and reporting accountant's integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are not eligible for appointment as company auditors, as well as those who are so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

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# Proposed Revisions to ISAs (UK and Ireland) 260, 265, 700 (Revised) and 720 Section A

## INVITATION TO COMMENT

### Background

1. The FRC is engaged in a major project to enhance the effectiveness of the stewardship role of boards and audit committees through corporate reporting and audit (the Effective Company Stewardship project). A key objective is to enhance the relevance and value of the audit for users and the public by stimulating greater transparency about the judgements made by management and auditors in the course of preparing and auditing financial statements.
2. In January 2011, the FRC issued the consultation paper *Effective Company Stewardship – Enhancing Corporate Reporting and Audit*. The paper contained a number of recommendations, responding to lessons of the financial crisis and building on changes already made, such as the new UK Corporate Governance Code and the introduction of the Stewardship Code for institutional investors. These recommendations included proposals for a more substantial communication role for audit committees and the revision of auditing standards to expand the nature and extent of the auditor’s communication and reporting responsibilities.
3. In September 2011, the FRC, having considered the responses received to the consultation paper, issued a feedback paper *Effective Company Stewardship – Next Steps*<sup>1</sup>. This stated that:
  - (i) The FRC believes that more needs to be done to demonstrate that auditors are achieving the fundamental purpose of an audit – namely to carry out an independent check into whether a company’s financial statements, including the decisions, judgements and estimates involved, have been properly prepared and are fair and balanced.
  - (ii) The FRC believes that auditors can and should provide increased insight into the audit process so as to reassure users of financial statements that all material matters have been properly disclosed.
  - (iii) To address the need for the contribution by auditors to be more transparent, the FRC proposes to review and consult on revisions to the auditing standards governing reporting by auditors to audit committees (ISA (UK & Ireland) 260) and audit reports (ISA (UK & Ireland) 700 (Revised)).
4. The feedback paper also set out specific recommendations for supplementary requirements that, in practice, would need to be included in ISAs (UK and Ireland) 260, 265, 700 (Revised) and 720 Section A.
5. This consultation paper was developed by the APB. It sets out, and invites comments on, changes now proposed, mostly in the form of limited additions to the ISAs (UK and Ireland), to implement the recommendations in the FRC feedback paper.

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<sup>1</sup> The feedback paper, and the original consultation and responses received, can be obtained at: [www.frc.org.uk/about/effcompsteward.cfm](http://www.frc.org.uk/about/effcompsteward.cfm)

## Summary of the proposed changes

6. The FRC's proposals - including the changes to auditing standards set out in this consultation paper developed by the APB - apply to those entities that are required, or choose voluntarily, to report on how they have applied the UK Corporate Governance Code ("UK Code reporting entities"). They are directed at:
  - a. **Enhancing auditor communications** by requiring the auditor to communicate to the audit committee:
    - i. information that the auditor becomes aware of in the course of the audit and that the auditor believes the audit committee will need in order to understand the rationale and the evidence relied upon when making significant professional judgments in the course of the audit and reaching an opinion on the financial statements. This will include the auditor's judgments made in planning the audit and the auditor's views about the key judgments made by management in preparing the financial statements; and
    - ii the auditor's insights about the entity's internal control system based on their audit work.
  - b. **Enhancing board reporting** by requiring boards, on a comply or explain basis, to set out in the annual report:
    - i. the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy; and
    - ii. the work of the audit committee in discharging its responsibilities, including the significant issues that it considered in relation to the financial statements (including consideration of matters communicated to it by the auditor) and how these issues were addressed.
  - c. **Extending auditor reporting** by requiring the auditor to report by exception if:
    - i. the board's statement in the annual report setting out the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy, is inconsistent with the knowledge acquired by the auditor in the course of performing the audit; and/or
    - ii. the matters disclosed in the section of the annual report describing the work of the audit committee do not appropriately address matters communicated by the auditor to the audit committee.
7. The proposed enhancements to board reporting are being introduced through proposed changes to the UK Corporate Governance Code and the related Guidance on Audit Committees<sup>2</sup>, which should be read alongside this consultation.
8. In addition, changes are being proposed to ISA (UK and Ireland) 720 Section A, to elevate from the application material to an explicit requirement the expectation that

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<sup>2</sup> The FRC consultation on proposed changes to the UK Corporate Governance Code and the Guidance for Audit Committees can be obtained from the Publications 2012 section of the FRC website ([www.frc.org.uk/publications/pubs.cfm?mode=list&year=2012](http://www.frc.org.uk/publications/pubs.cfm?mode=list&year=2012)).

when the auditor reads the other information, the auditor does so in the light of the knowledge the auditor has acquired during the audit.

### **An objective-based approach**

9. In setting out the proposed requirements in the UK Corporate Governance Code and in the ISAs (UK and Ireland), there is a tension between achieving consistency and comparability of reporting by entities and achieving relevant and useful reports. In the feedback in response to the Effective Company Stewardship proposals, many thought that audit committee reports that dealt with the main issues discussed by the committee, rather than process, would provide reassurance that the audit committee was operating effectively and properly discharging its responsibilities.
10. The FRC and the APB recognise that over-prescriptive reporting requirements can encourage boilerplate. The proposals to amend the Code and guidance and the auditing standards have therefore been cast in terms of the objectives to be achieved, rather than the detail of how to do so. The FRC and the APB believe that this approach provides the best prospect of ensuring that audit committee reports are meaningful and individual to the entities concerned.

### **Scope of the proposed new requirements**

11. Most of the proposed changes are intended to be applicable only to UK Code reporting entities. However, it is proposed that the changes to ISA (UK and Ireland) 720 Section A should be applicable to all audits. The reasons for this are explained below (see paragraph 20).
12. It is expected that these new requirements will apply mostly to group audits. However, the APB does not consider that it is necessary to add any specific new requirements to ISA (UK and Ireland) 600, *Special considerations – audits of group financial statements (including the work of component auditors)*. That standard includes a requirement (in paragraph 41) for the group engagement team to request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit (which specifically includes identified deficiencies in internal control at the component level, 'other significant matters' that the component auditor is communicating to those charged with governance of the component, and any other matters that may be relevant to the group audit). Accordingly, the group engagement team is able to request from component auditors such information as the group engagement team may consider appropriate to enable them to fulfil the proposed new communication and reporting requirements set out in this consultation paper.

<b>Q1 Is the scope of the proposed changes appropriate? If not, please explain the scope you consider would be appropriate.</b>
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### **Effective date**

13. The FRC is also proposing further revisions to the UK Corporate Governance Code and the related Guidance for Audit Committees, with the intention that these should be finalised and effective for reporting periods commencing on or after 1 October 2012. The proposed changes to the auditing standards support the proposed changes to the

corporate governance regime and the APB intends that they should have the same effective date.

**Q2 Is the proposed effective date, which is linked to the intended effective date of the FRC’s proposed revisions of the UK Corporate Governance Code, appropriate? If not, please give reasons for your view and indicate the effective date that you would consider appropriate.**

**Proposed revisions to ISAs (UK and Ireland) 260 “Communication with those charged with governance” and 265 “Communicating deficiencies in internal control to those charged with governance”**

14. As noted above, a key objective of the FRC’s Effective Company Stewardship project is to enhance the relevance and value of the audit for users and the public by stimulating greater transparency about the judgements made by management and auditors in the course of preparing and auditing financial statements. The FRC believes that the primary responsibility for providing information to achieve this greater transparency rests with the audited entity and, accordingly, that there should be a section of the annual report describing the work of the audit committee in discharging its responsibilities that will, inter alia, help provide increased insight into the judgements made by management and auditors .
15. Under the proposed revisions to the UK Corporate Governance Code, the description of the work of the audit committee should include the significant issues that it considered in relation to the financial statements and how these issues were addressed and this description should appropriately address matters communicated to the audit committee by the auditor. The responsibilities of the audit committee also include advising the board whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity’s performance, business model and strategy, and to report to the board the basis for that advice.
16. To assist the audit committee, the FRC proposed that the standards governing the provision of reports by auditors to audit committees should be revised to ensure that auditors are required to provide audit committees with the information that that they need to understand the rationale for, and the evidence relied upon in making, the auditor’s significant professional judgments in the course of the audit and in reaching their audit opinion.
17. The objective of the proposed revisions to ISAs (UK and Ireland) 260 and 265 is to establish these requirements, including specifying the matters that, at a minimum, the FRC believes auditors should communicate to audit committees.

**Q3 Are the proposed changes to ISAs (UK and Ireland) 260 and 265 appropriate? If not, please give reasons and, if applicable, indicate how you believe they should be modified.**

**Proposed revisions to ISAs (UK and Ireland) 700 (Revised) “The auditor’s report on financial statements” and 720 Section A “The auditor’s responsibilities relating to other information in documents containing audited financial statements”**

18. To further give greater transparency to the work carried out by auditors in relation to the annual report as a whole, the FRC proposed that auditors should be required to report whether the review they undertake of the annual report under ISA (UK & Ireland) 720 has revealed any information which is incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.
19. ISA (UK and Ireland) 720 Section A currently requires auditors to read the other information included in documents containing audited financial statements (e.g. the narrative information in the annual report) to identify material inconsistencies, if any, with the audited financial statements. The related application material in the standard indicates that when the auditor reads the other information, the auditor does so in the light of the knowledge the auditor has acquired during the audit.
20. The objective of the proposed revision to ISA (UK and Ireland) 720 Section A is, in effect, to elevate the application material described above to an explicit requirement, amended to better reflect the FRC’s specific proposal, stipulating that the auditor also reads the other information to identify any information that is apparently incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit. This proposed revision relates to work that users of financial statements generally would expect auditors to be undertaking already and, on this basis, the APB believes that it should be effective for all audits and not just those of UK Code reporting entities.
21. The objective of the proposed revision to ISA (UK and Ireland) 700 (Revised) is to introduce a requirement for auditors of UK Code reporting entities to report by exception if, when reading the other financial and non-financial information included in the annual report, they identify information that is materially inconsistent with the information in the audited financial statements or is apparently incorrect based on, or materially inconsistent with, the knowledge acquired by them in the course of performing the audit.
22. Under the current requirements of ISA (UK and Ireland) 700 (Revised), auditors are required to describe in the auditor’s report on the financial statements the matters on which they are required to report by exception and to incorporate a suitable conclusion in respect of such matters. The combined effect of these proposed new and existing requirements is, as intended by the FRC, to require auditors of UK Code reporting entities to provide an explicit conclusion on whether they have anything to report arising from their work under ISA (UK and Ireland) 720 Section A. For such entities, this would include considering the enhanced board reporting described in paragraph 6.b above and providing an explicit conclusion as to whether:
  - a. The board’s statement in the annual report – setting out the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity’s performance, business model and strategy – is inconsistent with the knowledge acquired by the auditor in the course of performing the audit; and/or
  - b. The matters disclosed in the section of the annual report describing the work of the audit committee do not appropriately address the matters communicated by the auditor to the audit committee.

23. However, the APB does not believe that it is appropriate at this time to extend to all audits the requirement to provide an explicit conclusion on whether they have anything to report arising from their work under ISA (UK and Ireland) 720 Section A.

**Q4 Are the proposed changes to ISAs (UK and Ireland) 700 (Revised) and 720 Section A appropriate? If not, please give your reasons and, if applicable, indicate how you believe they should be modified.**

**Q5 Do you agree that it would be inappropriate to extend to all audits the reporting requirement to provide an explicit conclusion arising from the auditor's work under ISA (UK and Ireland) 720 Section A? If not, please give your reasons.**

### **Regulatory Impact Assessment**

24. The FRC feedback paper on Effective Company Stewardship indicates that its proposals would not affect the underlying work undertaken by auditors under existing auditing standards - only its transparency. The proposed changes to the auditing standards set out in this consultation paper do not require auditors to perform more verification work, but primarily expand, and enhance, the auditor's communication and reporting responsibilities on the basis of work already required to be undertaken.
25. The expanded communication and reporting responsibilities are only proposed to be mandated for the audits of UK Code reporting entities. There may be an increase in time and materials to support communications with audit committees, and in the related audit documentation, but the APB believes that the associated costs will not be significant in relation to the total audit costs and will be outweighed by the benefits to audit committees complying with the proposed changes to the UK Corporate Governance Code and the enhanced transparency of the audit that will benefit users of the financial statements.
26. The change to ISA (UK and Ireland) 720 Section A is proposed to be applicable to all audits but, as indicated above, is in effect mandating work that generally users of financial statements would expect auditors to be undertaking already and indeed is already indicated by the current application material in the standard. The introduction of an explicit requirement may cause a small amount of further audit documentation to be required but the APB would not expect the associated costs of this to be significant in relation to the total audit costs. The APB believes there is a clear benefit in all audits in the auditors reading the other information to identify any information that is apparently incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit.

**Q6 Do you agree that the associated costs of the proposed changes should not be significant compared to total audit costs? If not, please give reasons and your estimate of the level of impact.**

**Q7 Do you agree that the benefits of the proposed changes will outweigh any costs? If not, please give reasons.**

## Other projects relevant to these auditing standards

27. The APB currently has out for consultation<sup>3</sup> proposed changes to the auditor reporting standards, including ISA (UK and Ireland) 700 (Revised), that are designed to enable the most recent standards to be used by auditors in the Republic of Ireland (currently, the pre ‘clarity’ reporting standards are still being used there). Those changes, if agreed, will affect some of the text reproduced in this consultation paper (specifically paragraph 16(a) of ISA (UK and Ireland) 700 (Revised), identifying the website locations of the description of the scope of an audit). However, they do not impact the proposals addressed in this consultation paper.
28. There are other projects currently being undertaken by the FRC and other bodies that may in due course result in further changes to these standards being proposed. These are:
- The Sharman Inquiry to identify lessons for companies and auditors addressing going concern and liquidity risks<sup>4</sup>.
  - The APB project on auditor scepticism<sup>5</sup>.
  - The BIS proposals for narrative reporting<sup>6</sup>.
  - The IAASB projects on auditor reporting<sup>7</sup> and the proposed revision of ISA 720<sup>8</sup>.
29. It is currently anticipated that none of the projects identified in paragraph 28 will have a direct impact on the auditing standards in 2012. The APB is monitoring the projects to seek to ensure that the proposed changes to the ISAs (UK and Ireland) set out in this consultation paper will not be inconsistent with further changes that may eventually be driven by these other projects.
30. The APB believes that it is necessary to make the proposed changes set out in this consultation paper during 2012, rather than waiting for developments in these other projects, to support the FRC’s proposed changes to the UK Corporate Governance Code.

## Commenting on the proposals

The APB is inviting comments on the changes proposed to be made to ISAs (UK and Ireland) 260, 265, 700 (Revised), and 720 Section A that are described in this consultation paper and illustrated in mark-up in the extracts from those standards. The APB is not inviting comments on other aspects of these ISAs (UK and Ireland).

The APB would prefer to receive letters of comment in an electronic form that facilitates “copy and paste”: these may be sent by e-mail to [k.billing@frc-apb.org.uk](mailto:k.billing@frc-apb.org.uk) . If this is not possible, please send letters of comment to:

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<sup>3</sup> [www.frc.org.uk/apb/publications/pub2716.html](http://www.frc.org.uk/apb/publications/pub2716.html)

<sup>4</sup> [www.frc.org.uk/about/sharmaninquiry.cfm](http://www.frc.org.uk/about/sharmaninquiry.cfm)

<sup>5</sup> [www.frc.org.uk/apb/publications/pub2343.html](http://www.frc.org.uk/apb/publications/pub2343.html)

<sup>6</sup> [www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation](http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation)

<sup>7</sup> [www.ifac.org/auditing-assurance/projects/auditor-reporting](http://www.ifac.org/auditing-assurance/projects/auditor-reporting)

<sup>8</sup> [www.ifac.org/auditing-assurance/projects/auditors-responsibilities-relating-other-information-documents-containin](http://www.ifac.org/auditing-assurance/projects/auditors-responsibilities-relating-other-information-documents-containin)

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**Letters of comment should be sent so as to be received no later than 13 July 2012.** All comments will be regarded as being on the public record unless otherwise requested, and will be posted to the APB's website soon after receipt.

EXPOSURE DRAFT

## **ISA (UK and Ireland) 260 – Communication with Those Charged with Governance**

Set out below are proposed additions to the requirements and application material to bring into effect the proposals described above in the Invitation to Comment. Existing requirements and application material have been reproduced where necessary to provide context (shading identifies the APB supplementary material added to the IAASB's ISA text). The full text of the current standard can be obtained from the Publications section of the APB website ([www.frc.org.uk/apb/publications/pub2083.html](http://www.frc.org.uk/apb/publications/pub2083.html)).

### **Requirements**

#### *Communication with a Subgroup of Those Charged with Governance*

12. If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5-A7-1)

#### *Planned Scope and Timing of the Audit*

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)

#### *Significant Findings from the Audit*

16. The auditor shall communicate with those charged with governance: (Ref: Para. A16)
- (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A17)
  - (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A18)
  - (c) Unless all of those charged with governance are involved in managing the entity:
    - (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A19)
    - (ii) Written representations the auditor is requesting; and
  - (d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A20)

### Entities that report on application of the UK Corporate Governance Code

16-1. In the case of entities that are required<sup>9</sup>, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, the auditor shall communicate to the audit committee the information that the auditor believes the audit committee will need (in the context of fulfilling its responsibilities under Code provision C.3.2) in order to understand the rationale and the evidence relied upon when making significant professional judgments in the course of the audit and reaching an opinion on the financial statements. If not already covered by communications under paragraphs 15 and 16 above, this information shall include, at a minimum, the auditor's views: (Ref: Para. A20-1 – A20-2)

- (a) about risks and materiality and the implications of those judgments for the overall audit strategy, the audit plan and the evaluation of misstatements identified;
- (b) on the appropriateness of the accounting policies (viewed individually and in aggregate);
- (c) on the valuations of the entity's material assets and liabilities and related disclosures provided by management; and
- (d) on any other matters identified in the course of the audit that, in the auditor's judgment, are relevant to the audit committee's advice to the board as to whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy.

### **Application Material**

#### *Communication with a Subgroup of Those Charged with Governance*

A7-1. 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, the auditor is required under paragraph 16-1 to communicate to the audit committee the information that the auditor believes the audit committee will need in order to understand the rationale for, and the evidence relied upon in exercising, the auditor's significant professional judgments in the course of the audit and in reaching the auditor's opinion on the financial statements. Audit committees are then, in turn, required to report to the board on various matters related to the discharge of their responsibilities, including those related to the financial statements, the annual report and the audit process (see paragraph A20-1 below). When considering whether the auditor needs to communicate with the board regarding matters communicated by the auditor to the audit committee, the auditor takes into consideration the adequacy of the communications between the audit committee and the board, including whether they appropriately address relevant matters communicated to the audit committee by the auditor. This may be achieved in one or more ways, including discussions with individual board members, a review of any written reports from the audit committee to the board or, in the case of oral communications, attendance at the relevant part of the board meeting where the audit committee delivers its report to the board.

<sup>9</sup> These include Premium Listed companies in the UK.

Communication with audit committees of entities that report on application of the UK Corporate Governance Code (Ref: Para. 16-1)

A20-1. Under the UK Corporate Governance Code, the responsibilities of the audit committee include advising the board on whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy; assessing the effectiveness of the audit process; and reporting to the board on how it has discharged its responsibilities. The supporting Guidance on Audit Committees indicates that the report to the board should include, inter alia:

- The significant issues that the audit committee considered in relation to the financial statements and how these issues were addressed; and
- The basis for its advice that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy.

In fulfilling these responsibilities, the audit committee will be assisted by an understanding of issues that involve significant judgment. This will include an understanding of the rationale and evidence for the auditor's significant professional judgments made in the course of the audit and in reaching the opinion on the financial statements, as communicated to the audit committee by the auditor in accordance with the requirements of paragraph 16-1, including relevant information communicated in accordance with the requirements of paragraphs 15 and 16.

A20-2. The Guidance on Audit Committees also sets out other matters the audit committee should consider in relation to the annual audit cycle, including in relation to the audit plan and the auditor's findings.

EXPOS

## ISA (UK and Ireland) 265 – Communicating Deficiencies in Internal Control to Those Charged With Governance and Management

Set out below are proposed additions to the requirements and application material to bring into effect the proposals described above in the Invitation to Comment. Existing requirements and application material have been reproduced where necessary to provide context (shading identifies the APB supplementary material added to the IAASB's ISA text). The full text of the current standard can be obtained from the Publications section of the APB website ([www.frc.org.uk/apb/publications/pub2084.html](http://www.frc.org.uk/apb/publications/pub2084.html)).

### Requirements

9. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)

9-1. In the case of entities that are required<sup>10</sup>, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code the auditor shall communicate to the audit committee the auditor's views on the effectiveness of the entity's system of internal control, based on the audit procedures performed in the audit of the financial statements, including the auditor's views on the effectiveness of that system in addressing risks arising from the entity's business model of which the auditor is aware and that in the auditor's opinion should be disclosed by the entity in the annual report. The auditor shall include with this communication sufficient information to enable the audit committee to understand the context within which the auditor's views are expressed, including, if not already communicated to the audit committee, the information specified in paragraph 11(b)(ii). (Ref: Para. A12-2 – A12-3)

11. The auditor shall include in the written communication of significant deficiencies in internal control:
- (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28)
  - (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30)
    - (i) The purpose of the audit was for the auditor to express an opinion on the financial statements;
    - (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
    - (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

<sup>10</sup> These include Premium Listed companies in the UK.

## Application Material

A12-1. In the UK and Ireland, where applicable, timely communication of significant deficiencies in writing to directors of listed entities can assist them apply the revised “Turnbull Guidance”<sup>6a</sup> on the requirements of the Combined UK Corporate Governance Code relating to internal control and reporting to shareholders thereon.

A12-2. Under the UK Corporate Governance Code, the responsibilities of the audit committee include reviewing the entity’s internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the entity’s internal control and risk management systems. As indicated in paragraph 11(b)(ii), for the purpose of the audit of the financial statements, the auditor does not design audit procedures for the purpose of expressing an opinion on the effectiveness of internal control, and accordingly does not express such an opinion. However, communication of the auditor’s views on the effectiveness of the entity’s system of internal control, based on the audit procedures performed in the audit of the financial statements, may help the audit committee fulfil this responsibility.

A12-3. The auditor’s understanding of the entity, including its risk assessment process, obtained in compliance with ISA (UK and Ireland) 315 may identify risks arising from the entity’s business model that the auditor believes would be appropriate for the entity to disclose in the annual report. The auditor’s views on the effectiveness of the entity’s system of internal control in addressing these risks may be helpful to the audit committee in its evaluation of whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity’s performance, business model and strategy. However, the auditor also makes clear to the audit committee that the audit only included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control.

<sup>6a</sup> “Internal Control – Revised Guidance for Directors on the Combined Code” issued by the Financial Reporting Council, October 2005.

## ISA (UK and Ireland) 700 (Revised) – The Auditor’s Report on Financial Statements

Set out below are proposed additions to the requirements and application material to bring into effect the proposals described above in the Invitation to Comment. Existing requirements and application material have been reproduced where necessary to provide context. The full text of the current standard can be obtained from the Publications section of the APB website ([www.frc.org.uk/apb/publications/pub2516.html](http://www.frc.org.uk/apb/publications/pub2516.html)).

### Requirements

#### *Scope of the Audit of the Financial Statements*

16. The auditor’s report shall either:
- (a) Cross refer to a “Statement of the Scope of an Audit” that is maintained on the APB’s web-site; or
  - (b) Cross refer to a “Statement of the Scope of an Audit” that is included elsewhere within the Annual Report; or
  - (c) Include the following description of the scope of an audit.

“An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the *[describe nature of entity]* circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by *[describe those charged with governance]*; and the overall presentation of the financial statements. 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 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.” (Ref: Para A8 – A9)

#### *Opinion<sub>s</sub> on Other Matters*

21. When the auditor addresses other reporting responsibilities within the auditor’s report on the financial statements, the opinion arising from such other responsibilities shall be set out in a separate section of the auditor’s report following the opinion[s] on the financial statements or, where there is one, the opinion on regularity. (Ref: Para A15 – A16)
22. If the auditor is required to report on certain matters by exception the auditor shall describe its responsibilities under the heading “Matters on which we are required to report by exception” and incorporate a suitable conclusion in respect of such matters. (Ref: Para A17 - A18)

23. In the case of entities that are required<sup>11</sup>, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, 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 that is materially inconsistent with the information in the audited financial statements or is apparently incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit. (Ref: Para A19-A20)

## **Application Material**

*Opinion~~s~~ on Other Matters (Ref: Para 21 – 2223)*

A19 Entities that apply the UK Corporate Governance Code are required to set out in the annual report the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy. Such entities are also required to include a separate section of the annual report that describes the work of the audit committee in discharging its responsibilities. This should include, inter alia, the significant issues that the audit committee considered in relation to the financial statements, including appropriate matters considered that were communicated to it by the auditor, and how these issues were addressed.

A20 Matters the auditor is required to report on by exception in accordance with paragraph 23 include, for entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, if:

- (a) The board's statement in the annual report setting out the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy, is inconsistent with the knowledge acquired by the auditor in the course of performing the audit; and/or
- (b) The matters disclosed in the section of the annual report describing the work of the audit committee do not appropriately address matters communicated by the auditor to the audit committee.

A suitable conclusion on these matters is included in the auditor's report in compliance with the requirement in paragraph 22.

<sup>11</sup> These include Premium Listed companies in the UK.

## ISA (UK and Ireland) 720 Section A – The Auditors Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements

Set out below are proposed additions to the requirements and application material to bring into effect the proposals described above in the Invitation to Comment. Existing requirements and application material have been reproduced where necessary to provide context (shading identifies the APB supplementary material added to the IAASB's ISA text). The full text of the current standard can be obtained from the Publications section of the APB website ([www.frc.org.uk/apb/publications/pub2106.html](http://www.frc.org.uk/apb/publications/pub2106.html)).

### Requirements

6. The auditor shall read the other information to identify material inconsistencies, if any, with the information contained in the audited financial statements. ~~(Ref: Para. A4-1 – A4-2)~~

6-1. The auditor shall also read the other information to identify any information that is apparently incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit. (Ref: Para. A4-1 – A4-4)

### Application Material

#### *Reading Other Information* (Ref: Para. 6-7)

A4-1. When the auditor reads the other information, the auditor does so in the light of the knowledge the auditor has acquired during the audit. The auditor is not expected to verify any of the other information. The audit engagement partner (and, where appropriate, other senior members of the engagement team who can reasonably be expected to be aware of the more important matters arising during the audit and to have a general understanding of the entity's affairs); reads the other information with a view to identifying significant misstatements therein or matters which are inconsistent with the financial statements or the knowledge acquired by the auditor in the course of performing the audit.

A4-2. If the auditor believes that the other information contains a material misstatement of fact, is materially inconsistent with the financial statements, or is otherwise misleading, and the auditor is unable to resolve the matter with management and those charged with governance, the auditor considers the implications for the auditor's report and what further actions may be appropriate. The auditor has regard to the guidance in paragraphs A11-1 and A11-2 below and, for entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, the requirement in paragraph 23, and related guidance in paragraph A20, of ISA (UK and Ireland) 700 (Revised) to report on matters by exception.

A4-3. Entities that apply the UK Corporate Governance Code are required to set out in the annual report the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy. Such entities are also required to include a separate section of the annual report that describes the work of the audit committee in discharging its responsibilities. This should include, inter alia,

the significant issues that the audit committee considered in relation to the financial statements, including appropriate matters considered that were communicated to it by the auditor, and how these issues were addressed.

A4-4. The auditor's consideration of whether the other information is materially inconsistent with the knowledge acquired by the auditor in the course of performing the audit includes consideration, where applicable, of:

- (a) Whether the statement in the annual report setting out the basis on which the board considers that the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy, is inconsistent with the knowledge acquired by the auditor in the course of performing the audit; and
- (b) Whether the matters disclosed in the section of the annual report describing the work of the audit committee do not appropriately address matters communicated by the auditor to the audit committee.

EXPOSURE DRAFT