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

(For audits of entities that report on how they have applied the UK Corporate Governance Code)

A proposed revision of International Standard on Auditing (UK and Ireland) 700
The auditor's report on financial statements

Comments from ACCA to the Financial Reporting Council 30 April 2013.

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ACCA welcomes the opportunity to comment on the proposals issued by the Financial Reporting Council (the FRC). UK members of the ACCA Global Forum for Audit and Assurance have considered the matters raised and their views are represented in the following.

OVERALL COMMENTS

We welcome the steps taken by the FRC to give effect to its Effective Company Stewardship proposals in the UK and Ireland. Taken together with other measures already put in place, we welcome and support the proposed revision of International Standard on Auditing (UK and Ireland) 700 *The auditor's report on financial statements.*

It is unfortunate that the FRC and the International Auditing and Assurance Standards Board have not been able to move forward together in the area of auditor reporting because of the well-known benefits of the application of global standards. We acknowledge, however, the need to respond in a timely fashion to pressure for change both in the UK and Ireland and at the level of the European Union.

We also note the structural advantage possessed by the FRC, which is capable of steering both auditing and corporate governance. Enhancements requiring co-ordination between corporate reporting and auditing are thus capable of implementation quickly and uniformly; something that is not currently possible globally.

As recognised in the consultation paper, the current proposals can be regarded as 'auditor commentary', a form of reporting on which the IAASB has consulted in its auditor reporting project. It is to be hoped, therefore, that the outcome of this FRC consultation will also benefit the development of global standards and that convergence to them in the UK and Ireland will ultimately be to an enhanced common position.

As we state in the body of this response, the benefits to be realised through the current proposals are best appreciated in the context of, and inseparably from, the other measures taken in relation to Effective Company Stewardship. We have not, therefore, sought to address the components separately.

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SPECIFIC COMMENTS

In this section of our response, we answer the 12 questions set out in the consultation paper.

OVERALL VIEW

Question 1 Do you agree that the auditor's report should include a description of the auditor's assessed risks of material misstatement, materiality and the audit scope? If not, why not?
As we have explained in our overall comments, the proposed new material in the auditor's report could be considered to be 'auditor commentary' as currently under debate at the IAASB. In ACCA's response to the IAASB Invitation to Comment *Improving the auditor's report* (October 2012) we expressed general support for the proposals because they responded to the needs, in particular of institutional investors and financial analysts, for more and better information to underpin the 'pass or fail' opinion.

The proposed descriptions provide an opportunity for auditors to demonstrate the soundness of their knowledge of the business. The increased transparency that is being called for will incentivise auditors to make and document sound professional judgements relating to descriptions. The discussion of the descriptions with those charged with governance may also result in improvements to corporate reporting for related matters.

However, we propose that the FRC proceed with caution in introducing the revisions to the ISA. An important thread running through the proposals is the need to avoid boilerplate reporting so that the auditor's descriptions better convey information about the specific audit. This naturally reduces the extent to which descriptions will be consistent and hence comparable. Without the benefit of dialogue with the auditor, users will find it challenging to understand technically difficult matters, such as materiality, and interpret the qualitative descriptions deriving from subjective judgements made by the auditor. There is considerable scope for misinterpretation. This we believe argues in favour of a cautious, unhurried implementation of the proposals, allowing sufficient time for all affected parties to develop a proper understanding. As the FRC is in advance of global standards there is a clear risk that, without this measured approach to implementation, UK and Ireland companies could be put at a disadvantage compared to foreign listed companies as certain disclosures from the auditor may cause concern to investors.

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Question 2 Do you agree that these proposals should be limited to entities that explain how they comply with the Code? If not, why not?
We agree that it is appropriate to limit the proposals to 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. This limitation is also incorporated into the proposed changes to implement certain recommendations of the Sharman Panel.

We have some concerns, however, that the proposals may deter voluntary compliance with the Code. If that were to be the case, it would be unfortunate. The current proposals are primarily focussed on the auditor, whereas the auditing consequences of the Sharman proposals result from new corporate governance disclosures. It would be possible to recognise this through making it possible for a company to comply voluntarily with the Code without having to have the auditor descriptions. We note that overseas companies with a UK listing would not, in any case, be within the scope of the proposals unless audited in accordance with ISAs (UK and Ireland). We believe that the FRC should engage on this matter with companies that comply, or may wish to comply, voluntarily with the Code.

Question 3 (a) Do you consider that the provision of such information by the auditor will be of benefit to shareholders and other users of the financial statements and, if so, can you explain what those benefits would be and how they would arise?
In addition to our comments above concerning the proposals of the IAASB, we stress that changes to reporting by the auditor as proposed by the FRC should be seen in the context of the whole of the FRC Effective Company Stewardship initiative in the UK and Ireland. Taken together, the enhanced reporting and the changed processes that support it are intended to yield the benefits already set out by the FRC. While we consider that there will be benefits, their extent will need confirmation by a post-implementation review.

Question 3 (b) Do you believe such information would provide an effective "hook" for investors and other users to start a dialogue with the company about the audit?
As part of the overall information available to investors and other users, the proposed provision of information by the auditor will be very relevant to the audit process. As such, it could be regarded as a 'hook' for starting a dialogue about the audit to the extent that investors wish to do so. Although such reporting does not allow a conclusion to be drawn about the quality of the audit, it certainly adds to the information relevant to that conclusion. More importantly, by exposing the auditor's views on risks, it contributes to, and may focus, the users' understanding of the company's own disclosures.

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Question 4 Do you believe that directors are likely to disclose information about the audit (of the type that would be required in accordance with these proposals) under the September 2012 changes to the Code? Is it more appropriate for such information to be provided in the auditor's report or by the board in the section of the annual report addressing the work of the audit committee, and why?
Had these proposals not been issued, we doubt whether the directors would have made disclosures of the type that would be required in accordance with these proposals. Now that the consultation paper is in the public domain, directors would be more likely to consider such disclosures but, clearly, if the auditor is ultimately required to make such disclosures, the directors would not want to duplicate that information.

Ultimately, it does not matter whether the information originates from the auditor or the board, so long as the shareholders and other users are similarly assured of its veracity. There does seem to be logic, however, in placing the disclosures within the responsibility of the primary actor irrespective of whether, in the case of auditor reporting, it has already occurred in the context of auditor and audit committee dialogue.

ASSESSED RISKS OF MATERIAL MISSTATEMENT

Question 5 What do you believe would be, if any, the benefits, costs and other impacts of the proposed requirement to describe in the auditor's report certain risks of material misstatement that were identified by the auditor?
The descriptions will likely be a subset of matters communicated to the audit committee and the benefits potentially a subset of the benefits derived by the audit committee (and company) from such information. Shareholders and other users have different perspectives from that of the audit committee, however, and it is through improving the information that they use to make decisions that additional benefits will accrue.

We do not believe it is sensible to try to separate out elements of the package of proposed enhancements to reporting in order to allocate between them the overall benefits, costs and other impacts. Even if this were possible, the relative worth of each element is likely to vary between audited entities and over time.

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Question 6 Do you agree that the basis for determining the risks of material misstatement to be described in the auditor's report (see proposed paragraph 16A(a) of ISA (UK&I) 700) is appropriate?
We agree with the general approach adopted. The nature of the assessed risks will be similar to those identified in ISA (UK & I) 315. However, we feel it is important that the auditor is able to apply judgement in determining the risks to be described. Please see the Appendix to this response for our suggestions for improving the wording of paragraph 16A(a).

Question 7 The risks disclosed by the auditor in complying with proposed paragraph 16A(a) of ISA (UK&I) 700 may well differ from the principal risks disclosed by the directors in the business review in the annual report. What are your views about this possibility?
Under C.3.8 of the Code, the report describing the work of the audit committee should include 'the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed'. We believe that shareholders and other users of the annual report would expect to see some overlap between these and the risks identified by the auditor, insofar as some of the issues may have been brought to the attention of the audit committee through the audit process.

Question 8 Do you believe that the omission from the auditor's report of a particular risk of material misstatement would pose a threat of significant loss or damage to the auditor if, after the event, it became evident that the risk had given rise to significant damage to the company?
Whether an auditor describes, or does not describe, a particular risk could not of itself cause significant loss or damage to the auditor as that would depend on the assessment (ultimately by a court) of whether the auditor had been negligent in that action or inaction.

The perception of increased risk can affect, however, auditor and user behaviour; in the latter case, perhaps changing the user's propensity to take legal action. Auditors may react to this risk in two ways: tending to disclose more to mitigate the risk of 'not disclosing enough' or disclosing less because they may be criticised as either breaching confidentiality or causing unnecessary concern in investors. This tension has been present for some years in relation to an emphasis of matter regarding going concern.

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While it is in the public interest for a duty of care to continue to apply to auditors it is unreasonable that the auditor should be held effectively responsible for the faults of others. Auditors' exposure to liability under the joint and several liability regime is widely thought to have encouraged audit firms to adopt defensive, or risk-averse, approaches to their work and reporting. ACCA outreach, through roundtables held across the world, has shown that fear of litigation has also a detrimental effect on innovation in audit, which is an important driver of quality. The FRC should ensure that it is only requiring reporting that auditors are both capable of and happy to deliver.

ACCA's position on this is explained more fully in the paper *Audit reform: aligning risk with responsibility*[1].

MATERIALITY

Question 9 How do you assess the benefits, costs and other impacts of the proposed requirement to provide in the auditor's report an explanation of how the auditor applied the concept of materiality in planning and performing the audit, including specifying the threshold used by the auditor as being materiality for the financial statements as a whole, and the balance between them?

As we explained in our answer to question 5, we do not believe it is sensible to try to separate out elements of the package of proposed enhancements to reporting in order to allocate between them the overall benefits, costs and other impacts.

Having said that, we believe that materiality in an audit sense is technically difficult and so it is likely that relatively fewer shareholders and other users will possess or develop the expertise to appreciate the underlying information content of materiality-related disclosures. Because of that, such disclosures could be considered to be less useful.

The level of detail suggested by paragraph A9B, and illustrated in the example report, is not appropriate because terminology and the implications for audit work depend on the specific methodology of an audit firm. Disclosure of aspects relating to materiality alone may not enable even expert users to appreciate properly their impact on the conduct of the audit. This is because in an audit sense the concept is bound up with that of reasonable assurance, to which professional judgements concerning audit risk and material misstatement are important throughout the audit.

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[1] http://www.accaglobal.com/content/dam/acca/global/PDF-technical/audit-publications/tech-af-arar.pdf

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It is instructive to remember that paragraph 4 of ISA (UK and Ireland) 320 *Materiality in planning and performing an audit* states that it is reasonable for the auditor to assume that users understand that financial statements are prepared, presented and audited to levels of materiality. The implication is, however, that it would be unreasonable to assume any greater understanding of materiality. This presents a challenge for those in the financial reporting supply chain to make efforts to improve the general understanding of materiality.

SUMMARY OF AUDIT SCOPE

Question 10 How do you assess the benefits, costs and other impacts of the proposed requirement to provide in the auditor's report a summary of the audit scope, and the balance between them? Does the illustrative disclosure in Section 3 provide a sufficient explanation of how the audit scope was responsive to the auditor's assessment of risks and materiality?
As we explained in our answer to question 5, we do not believe it is sensible to try to separate out elements of the package of proposed enhancements to reporting in order to allocate between them the overall benefits, costs and other impacts.

We find the illustrative disclosure in Section 3 unsatisfactory, because it focusses on the allocation of resources rather than answering for users the wider questions they may have arising from the auditor's description of risks.

AVOIDING STANDARDISED LANGUAGE

Question 11 Do you believe that the wording of paragraph 16A and paragraphs A9A to A9C is sufficiently principle-based so as to avoid standardised language?

We agree that a principles-based requirement is preferable to prescription of the language.

Paragraph 16A does not specify wording directly, but it uses words that are likely to find their way into descriptions, such as 'assessed risks of material misstatement' and 'materiality for the financial statements as a whole'. The Application Material is also drafted in such a way that it directs auditors' language towards what could easily become boilerplate.

We note that, while the intention is not to provide examples in the long term, the example in Section 3 is nevertheless likely to be influential in determining the subject matter, length and order of descriptions.

Please see the Appendix to this response for our suggestions concerning the detail of the wording of paragraph A16.

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EFFECTIVE DATE

Question 12 Do you foresee any difficulty if the effective date is periods commencing on or after 1 October 2012.
The potential benefits stemming from the proposals will only be achieved if the new information provided by auditors is effective in meeting investor needs. As we have pointed out in our answer to question 1, sufficient time should be allowed, therefore, for affected parties to properly understand and prepare for what is a reporting change of considerable magnitude.

We do not support the proposed effective date of 'for periods commencing on or after 1 October 2012'. It is important for all parties that, at the start of an audit, a definitive standard is in place so that the form of report may be anticipated. Otherwise, the quality of reporting may suffer and uncertainty will reduce the enthusiasm for adoption of the changes.

Because of the importance of the proposed changes to the auditor's report, the commencement date should not be earlier than a year from the date of issue of revised ISA (UK & I) 700 (although early adoption should be encouraged).

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APPENDIX

DETAILED SUGGESTIONS CONCERNING PARAGRAPH 16A

> *16A. 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's report shall:*
>
> *(a) Describe those assessed risks of material misstatement that were identified[1] by the auditor and which[2] had the greatest effect on: the overall audit strategy[3]; the allocation of resources in the audit[4]; and directing the efforts of the engagement team[5];*
>
> *(b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit[6]. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole; and*
>
> *(c) Provide a summary of the audit scope[7], including an explanation of how such scope was responsive to the assessed risks disclosed in accordance with (a) and the auditor's application of materiality disclosed in accordance with (b).[8] (Ref. Para A9A – A9C)*

Comments

1 The word 'identified' is unnecessary, as the auditor cannot describe unidentified risks. If the intention is to use wording from the definition of 'significant risk' ('An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.') it should be done directly.

2 It is difficult to decide whether this whole sentence carries one connected definition, or if elements can be separated. For example, in order to be described, does a risk have to affect all three matters after the colon?

3 Given the all-encompassing nature of the 'overall audit strategy' it arguably includes the allocation of resources in the audit and directing the efforts of the engagement team; so there is no need to separate these elements.

4 ISA (UK & I) 300 refers to both the amount of resources to allocate and to the deployment of resources. Allocation is related to judgements on the suitability of resources to a particular circumstance, for example the audit budget in hours to allocate to a high risk area (ISA (UK & I) 300 paragraph A8). Deployment involves consideration of which team members or whether an expert is involved and aspects of timing – such as an interim audit stage. In keeping with this terminology, it would be better to say 'the deployment of resources'.

5 A simpler approach would be to refer to 'those significant risks that had the greatest effect on the audit'.

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6 ISA (UK and Ireland) 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing (UK and Ireland)* explains that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. Aspects of paragraph A9B pertain to the evaluation of the effect of identified misstatements and we are not convinced that paragraph 16A(b) confines the explanation (see comment 8 below) as presumably intended. Given that the explanation may be discussed by lawyers, there is a sound argument for supporting the auditor's right to include in the explanation matters more obviously pertaining to evaluation if that, in the auditor's judgement, is necessary to properly inform users. We suggest in the circumstances that 16A(b) should be:

> *Provide an explanation of how the auditor applied the concept of materiality in the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole; and*

7 The term 'audit scope' appears only once in ISAs (UK and Ireland) and although used here in the correct context (ie a reference to the number of locations to be included), without the benefit of the example report, auditors would assume that users would prefer to receive a more considered description of the auditor's response to the other matters described.

8 We would prefer to use consistent language in the subparagraphs rather than 'describe', 'provide an explanation' and 'provide a summary'.

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