FRC 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)

RESPONSE FROM ICAS TO THE FRC

30 APRIL 2013
Background

ICAS welcomes the opportunity to comment on the FRC’s Invitation to comment on the 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 (for audits of entities that report on how they have applied the UK Corporate Governance Code).

1. We are a professional body for over 19,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, financial services, industry, the investment community and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK’s and the world’s great companies.

2. Our Charter requires its Committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key Points

We welcome this proposal by the FRC and the recognition that the topic of auditor reporting is currently the subject of considerable international interest. Whilst we welcome the general direction of travel we would like to highlight that we believe there is a need for at least some of the material which the FRC might expect to be included in the proposed audit report to be included in the report produced by the audit committee of the entity concerned. We see no merit in the auditor having to repeat such content unless he believed there was merit in actually doing so e.g. to highlight or to provide additional explanation if considered necessary. This position is similar to our response to the IAASB Invitation to Comment (ITC), Improving the Auditor’s Report, in October 2012 and is based on some of the earlier work undertaken by ICAS considering how improvements could be made to corporate reporting and related assurance.

In December 2010, ICAS published its ‘Future of Assurance’ report. This report recommended that more information should be communicated to stakeholders via the annual corporate report. However, the preferred mechanism for delivering that information at that time was via the audit committee report to provide a greater understanding of the function of the audit committee and how they had discharged their duties. The Working Group recommended that:

“A more transparent audit committee is achieved through greater disclosure of its activities. An expanded audit committee report is required and should include: A matrix-style report which maps the key risks disclosed by the Board in its report to the assurance processes used to gain assurance over those risks: A substantive discussion of how the audit committee satisfied itself of the appropriateness of management’s judgements: Details of the key areas discussed between the audit committee and the auditors, including the main areas of audit challenge.”

The Working Group also recommended that additional reporting should be required of the auditor but was very much of the view that in the first instance the reporting from the directors of the entity should be increased and improved. The document can be downloaded at: http://icas.org.uk/futureofassurance/.

Since the publication of the report, ICAS is aware of the general move towards seeking to include more and better information in the auditor’s report. ICAS is supportive of the ultimate aim of enhancing the quality of information that is made available to shareholders and other stakeholders via corporate reports but believes that this aim can only be achieved by better reporting, both by the entity and by the auditor.
We would therefore favour a move towards requiring the auditor to provide greater assurance and we would welcome those responsibilities being extended to the provision of greater assurance resulting in a positive opinion on the narrative content of the annual report.

We believe that only by seeking for the auditor to provide assurance on the whole of the annual report can the profession really respond to the criticisms which have been levelled at it in relation to statements such as that of the UK Treasury Select Committee which questioned the value of audit in its report of May 2009.

ICAS published a research report in 2010 entitled “Meeting the Needs” by Ian Fraser and William Henry which suggested “significant demand for at least some degree of external assurance on management commentary”. The report also highlighted concern that the narrative commentary around risks and future prospects may become boilerplate or subject to management spin, therefore external assurance may go some way to addressing this concern.

Recently, ICAS issued a discussion paper which will offer guidance on how auditors might provide such an opinion entitled: “Balanced and Reasonable: Considerations Relating to the Provision of Positive Assurance on Management Commentary”. We would welcome your comments and feedback on some of the questions that the paper poses and your participation at some of the workshops we intend to host during 2013. The paper can be downloaded at: http://icas.org.uk/auditing/publications/.

In relation to the proposed implementation date, we are concerned about the timing of the FRC’s consultation on the revised ISA 700. It is expected that the IAASB will issue their own Exposure Draft of a revised auditor’s report, on which we also intend to comment, in June 2013 and we believe that it may have been advisable for the FRC to delay the issue of their proposals until further details on the content and requirements of the IAASB’s Exposure Draft were made publicly available. We would suggest that the FRC should delay implementation of the revised ISA 700 until the content of the IAASB’s Exposure Draft becomes known.

Our responses to the specific consultation questions

*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?

**Response 1:**
We believe that the inclusion of a description of the auditor’s assessed risks of material misstatement, materiality and the audit scope should enhance the relevance and informational value of the auditor’s report and should provide users with greater information and insight into the audit process.

The inclusion of such details would ensure that the report would be more entity-specific and provide users with a greater understanding of the operational issues which affect the entity.

**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?

**Response 2:**
We believe that the proposals should be limited to those entities that explain how they comply with the Code as these new disclosures are likely to be of lesser value to some smaller owner-managed entities, whose financial statements will not have the same level of public interest, or be subject to the same level of external scrutiny.
**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?
(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?

**Response 3:**
(a) We consider that the provision of such information by the auditor will be of benefit to shareholders and other users of financial statements, providing a description of the auditor’s assessed risks of material misstatement, materiality and the audit scope and thereby enhancing the relevance and informational value of the auditor’s report. This information should also provide users with greater information and insight into the audit process.

The inclusion of such details would ensure that the report would be more entity-specific and provide users with a greater understanding of the significant issues identified and discussed during the audit.

(b) We believe that having access to this information and a greater understanding of the audit process might encourage investors and users to start a dialogue with the company about the audit.

**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?

**Response 4:**
We believe that it is appropriate for directors to disclose at least some of the information about the audit in accordance with the changes to the Code, in particular in relation to key assumptions and judgements applied and the significant risks to which the entity is exposed. We believe that it is appropriate for this information to be disclosed in the section of the annual report addressing the work of the audit committee as we do not consider that it is appropriate for the auditor to be the provider of any new information relating to the entity.

**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?

**Response 5:**
We believe that there should be no significant increase in the amount of audit work required to comply with the requirements of the revised auditor report, however, additional time and costs will be required for senior members of the engagement team, including the engagement partner, to discuss some of the key risks of material misstatement with senior management within the entity. The additional time and costs are not expected to be significant and we believe that these costs will be exceeded by the potential benefits which include an increase in the perceived value of audit as users acquire a greater understanding of what is involved in the audit process from the additional information provided.
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?

Response 6:
We agree that the basis for determining the risks of material misstatement to be described in the auditor’s report per paragraph 16A (a) of ISA (UK&I) 700, is appropriate and should provide users with greater information and insight into the key issues identified by the auditor during the audit process.

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?

Response 7:
We consider that the risks disclosed by the auditor should be left to the auditor’s professional judgement as these areas will be based upon his/her assessment of the significant and relevant matters that should be disclosed to users, and this will vary from entity to entity. The responsibility for expressing the key risks affecting the organisation lies with those charged with governance and not the auditor. The auditor's responsibilities lie in the reporting of the key risks and judgements considered during the audit process when determining the audit opinion on the truth and fairness of the financial statements. These risks may not be the same as those identified by management in the business review.

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?

Response 8:
We do not believe that the auditor should be penalised for not having the benefit of hindsight and not identifying a risk arising as a result of unknown or unpredictable future events. As stated in our response to question 7, we believe that the risks disclosed by the auditor should be left to the auditor’s professional judgement; however, we do not believe that the auditor’s report should contain new information relating to an entity. We would prefer to see this information disclosed in the report of the audit committee/ those charged with governance, with the auditor commenting on these disclosures in the auditor’s report to add emphasis and highlight key issues and risks.

However, we consider that there might be a need for some form of protection, from possible action against the auditor by an investor or other stakeholder, should the omission of such a risk of material misstatement allegedly result in significant loss or damage to the company. Addressing this possibility may require further consideration and revision of the auditor liability regime which strengthens the argument in our response to question number 12 for delaying the proposed implementation date to allow sufficient time to examine this issue.

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?
**Response 9:**
We believe that there may be some benefit in the inclusion of an explanation of how the materiality concept has been applied within the auditor’s report but would urge caution when disclosing the thresholds used. We do have some concerns over the terminology used, namely with regard to references to planning and performance materiality, and how straightforward these concepts are for external parties to grasp. Our concerns lie in the belief that users who understand the concept of materiality are already well-informed and ask the relevant questions anyway, and fear that this disclosure might lead to more questions around the actual definition and concept of materiality than it seeks to answer.

We also believe that requiring such information might result in more boilerplate disclosures due to the reluctance of the auditor to quantify the materiality threshold applied. This reluctance may stem from the auditor’s concern that the materiality threshold applied might be challenged by another party who considers the level of materiality used to be inappropriate. As a result, the auditor may resort to disclosing as little information as possible, and referring to the materiality threshold as falling within a range, a disclosure that could form part of a generic statement applied to all entities, and, as a result, lead to more boilerplate reporting.

We also have some concerns that the information provided within the materiality paragraph in the example in appendix 3 is too numbers-orientated and should also reflect the more qualitative aspects 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?

**Response 10:**
We believe that the benefits and other impacts of the proposal to include a summary of the audit scope within the auditor’s report should outweigh the extra costs incurred, which we do not envisage being significant. We would welcome some clearer signposting between the significant risks identified and the audit scope disclosures to demonstrate how each of the significant risks has been tackled and addressed.

Overall, we welcome this enhanced disclosure of the audit scope as it provides a helpful insight into the audit process and the extent of work undertaken on the key areas identified.

**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?

**Response 11:**
As detailed in our response to question 9, we believe that the wording of paragraph 16A and paragraphs A9A to A9C could result in the auditor statement on materiality becoming boilerplate.

In addition, within paragraphs A9A to A9C, we would recommend that it is made explicitly clear that these proposals are only required for companies applying the UK Corporate Governance Code. Although this is implied in paragraph A9B through references to the audit committee, we would welcome a clear reference to this effect.
Effective date

Question 12:
Do you foresee any difficulty if the effective date is periods commencing on or after 1 October 2012?

Response 12:
We understand that the reason for the implementation date of periods commencing on or after 1 October 2012 is to be consistent with the changes to the Corporate Governance Code which take effect from this date. However we believe that the additional disclosures and information reported in the proposed revised ISA 700 will require greater engagement with management and audit committees to ensure that they understand and appreciate the full impact of the information relating to the audit process that will now be available in the public domain. We are concerned that the proposed effective date will not allow sufficient time for auditors and directors to undertake and participate in these discussions.

Furthermore, it is expected that the IAASB will issue their own Exposure Draft for a revised auditor’s report in June 2013, on which we also intend to comment, having already responded to the Invitation to Comment in October 2012. The timing of the FRC’s consultation on the revised ISA 700 is therefore questionable and we believe that it may have been advisable for the FRC to delay the issue of their proposals until further details on the content and requirements of the IAASB’s Exposure Draft were made publicly available. We would suggest that the FRC should delay implementation of the revised ISA 700 until the content of this Exposure Draft becomes known.

As already highlighted in our response to question 8, we also believe that more time needs to be given to consideration of the auditor liability regime in the event of a possible action being raised against the auditor.