BALANCED AND REASONABLE

A discussion paper on the provision of positive assurance on management commentary
BALANCED AND REASONABLE

CONSIDERATIONS RELATING TO THE PROVISION OF POSITIVE ASSURANCE ON MANAGEMENT COMMENTARY

A DISCUSSION DOCUMENT
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FOREWORD

In December 2010, the ICAS ‘Future of Assurance’ Working Group published its report containing a number of recommendations on the future provision of assurance and related corporate reporting matters. We are pleased to note that a number of those recommendations have been taken forward, either by bodies such as the Financial Reporting Council (FRC), or have been backed by respected bodies such as the House of Lords Economic Affairs Committee. One of the key recommendations in the report was that the corporate report of a listed entity should tell a coherent story of the business, with the Board signing off that the narrative is, in its view, ‘balanced and reasonable’.

Furthermore, the Working Group recommended that the company’s auditor should include an opinion on whether the annual report (excluding the financial statements) is ‘balanced and reasonable’ and that this opinion should be delivered using the auditor’s existing knowledge and understanding of the business, with some additional work where necessary. The Working Group envisaged that the auditor would provide a positive opinion as to whether the management commentary was ‘balanced and reasonable’. The House of Lords Economic Affairs Committee backed this recommendation in its report of March 2011. We also welcome more recent developments such as the FRC requiring auditors to report by exception where the annual report of a listed entity is not fair, balanced and understandable. The journey therefore has started towards the auditor providing greater assurance over the narrative section of the annual report.

That brings us to the next stage in the increasingly important journey that the Working Group envisaged, which is to consider how the auditor can provide a positive opinion as to whether the management commentary is ‘balanced and reasonable’. This paper explores the issues involved and suggests a means by which this could be achievable. The proposals outlined will involve considerable change for a number of parties. However, ICAS welcomes change as a necessary part of the innovation required to ensure that the accountancy profession remains at the forefront of developments in corporate reporting and assurance thereon. ICAS has spent considerable time discussing these issues in-house and believes that now is the opportune time, with developments in Integrated Reporting (IR) continuing apace, to allow others to have their say. I should like to take this opportunity to invite you to please take part in this debate – the future of assurance does not belong to ICAS alone. We look forward to having the conversation.

On behalf of ICAS, I would like to thank Jim Bishop (Partner, Ernst & Young/Convener of the ICAS Audit & Assurance Committee), Philip Johnson (Past President of FEE) and Allister Wilson (Partner, Ernst & Young/Convener of the ICAS Research Committee) who kindly took part in the review process and provided helpful and constructive comments on the paper.

Sir David Tweedie
ICAS President
EXECUTIVE SUMMARY

Introduction

The auditing profession has been the subject of some criticism, in the wake of the recent global economic crisis, for apparent failures in exposing the financial problems that existed, particularly within the banking sector. Whilst there is an absence of persuasive evidence that this is in fact the case, the value of the audit process to stakeholders and users of financial statements has been called into question. Currently, the extent of assurance provided by the auditor over the management commentary (narrative information) disclosed in the annual report is generally limited to a consistency check with the content of the financial statements. However, there appears to be a growing demand amongst users for the provision of a positive opinion on the narrative information, similar to the current ‘true and fair’ opinion provided on the financial statements.

This idea of a positive opinion on management commentary was recommended by the ICAS ‘Future of Assurance’ Working Group in its report of December 2010. The Working Group was tasked with identifying and recommending where improvements could, based on earlier research on users’ needs, be made in both corporate reporting and assurance regimes. The Working Group’s conclusion was that an additional opinion should be given over the disclosures and assumptions made by management in the narrative content within the annual report. The Group did however recognise that this assurance would differ from that provided by the auditor on the financial statements. The Group suggested that this explicit opinion should confirm that the narrative content of the annual report, which should include a description of the reporting entity’s activities, competitive position, business model, business drivers, strategy, risks and the key areas of judgement, presented a ‘balanced and reasonable’ reflection of the business’s performance, position and future prospects. Recent international developments in Integrated Reporting <IR>, and initiatives within the UK from the Department for Business, Innovation and Skills (BIS) on the Future of Narrative Reporting, advocate a move to a more holistic and strategy-oriented corporate report to improve the transparency and usefulness of the information provided.

The aim of this discussion paper is to highlight the considerations relating to the provision of an opinion that the narrative information presented is ‘balanced and reasonable’. The paper has been presented on the basis that the assurance to be provided on the management commentary will be provided by the auditor of the organisation concerned. Whilst in our view this would appear to be the most pragmatic and cost efficient means of doing so, such an assurance engagement could possibly be provided by another professional accountancy firm, other than the auditor.

Key principles

The paper suggests some of the processes that the auditor should follow when delivering an opinion on the narrative information. It takes the requirements of the current International Standards on Auditing (ISAs) and suggests how these can be applied and extended to the narrative content of the annual report. Additionally, many of these suggestions have been based on certain of the International Standards on Assurance Engagements (ISAEs), which, like the ISAs, are issued by the International Auditing and Assurance Standards Board (IAASB).

Need for a positive opinion

There is concern amongst some members of the profession over whether it is possible to
provide a positive opinion on some of the narrative information disclosed in the annual report, particularly in relation to forward-looking information. ICAS believes that a positive opinion is necessary to regain the trust and confidence of users and stakeholders, but we acknowledge that it will require courage and confidence on the part of the auditor to be willing to commit to such assurance, as well as a change in mindset and approach to the application of the assurance process. This might not be as big a step as might be envisaged: in current audit engagements, much of the information on which the auditor relies is not capable of being externally or objectively verified and many of the more risky judgements within the financial statements are already based on forward-looking assumptions e.g. impairments, level 3 financial instrument valuations, pension liabilities and provisions.

We envisage that a new assurance spectrum may require to be developed to meet the needs of users in the future. It is envisaged that such a spectrum would allow auditors to provide a broader range of assurance than is possible at present. We believe that a ‘balanced and reasonable’ opinion will take the form of a ‘medium assurance’ engagement, which would provide a lower level of assurance than that provided by an audit engagement, but greater than that provided by a review engagement. We are aware that a ‘medium assurance’ engagement is a new concept and will require a change to the IAASB’s existing two-tier assurance framework to provide that broader spectrum of possible assurance levels. We also appreciate that this will involve educating both auditors and also stakeholders, so as not to create new expectation gaps.

Broader application

It is hoped that a framework can be developed which can then be adapted to other reports containing narrative information, financial and non-financial information, future-oriented information and Integrated Reporting (IR).

Key questions

In section 5 of this paper, we have prepared a list of questions covering the main concerns and implications surrounding the provision of assurance on narrative information. The fundamental questions we believe that are raised by this paper are:

1. Do you agree that users need assurance over the front half of the annual report? If yes, do you believe that the proposed ‘balanced and reasonable’ opinion supported by an appropriate framework, based on the guidance in this paper, will meet users’ needs?
2. Have we identified the appropriate additional procedures in section 2.2 which an auditor would need to undertake to give a ‘balanced and reasonable’ opinion on the narrative section of the annual report?
3. Is the benefit to users from this new opinion likely to exceed the cost of this additional work?

The questions in section 5 can also be found at the end of the section to which they relate.

We would invite responses to all of the questions from interested parties in addition to any other comments or observations. Comments should be sent to Anne Adrain at aadrain@icas.org.uk, by 31 October 2013. We also intend to hold workshops in London and Edinburgh later in the year. If you would like to attend one of those workshops, please contact Anne Adrain at the above address.
1 BACKGROUND

1.1 ‘Future of Assurance’ Working Group

Following the recent financial crisis, various reviews have been undertaken to assess the role of auditors in events leading up to the crisis. On 15 May 2009, the House of Commons Treasury Select Committee (TSC) published its ninth report of session 2008-09 entitled Banking Crisis: reforming corporate governance and pay in the city. Chapter six of the report reviewed the performance of auditors leading up to the crisis. The TSC concluded at paragraph 221 of the report that there was little evidence to suggest that the auditors of the banks had not fulfilled their current responsibilities:

“We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient.”

However, the TSC also highlighted that there were concerns over how valuable audit actually is:

“But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in ‘tunnel vision’, where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.”

In response to these comments and those of a similar nature expressed by other stakeholders, ICAS established a Working Group in the summer of 2010, to examine the future provision of assurance and specifically to recommend where improvements could be made, both in the corporate reporting model and the assurance provided. The Group published its report in December 2010 and one of its key recommendations was that the auditor should be asked to provide assurance over the front-half of a listed company’s annual report i.e. the management commentary section. This assurance would not be provided on a traditional audit ‘true and fair’ sense but rather on a new basis of ‘balanced and reasonable’. This recommendation for broadening the scope of assurance provided by auditors was backed by the House of Lords Economic Affairs Committee’s report on its inquiry ‘Auditors: Market Concentration and their Role’, which concluded in March 2011.

The audit profession itself has acknowledged the need to regain the trust and confidence of external stakeholders and there is a growing acceptance within the profession that current audit reports may be of limited benefit to external stakeholders, as their current primary focus is on the financial statements which are historical in nature and comprise mainly quantitative information and related notes. Many investors place considerable importance on the content of the front-half of the annual report (management commentary) and yet much of the information contained in this section of the annual report is subject only to a consistency check with the information contained in the financial statements. From ICAS research undertaken surrounding the question: Can we meet the needs?, one of the comments from a non-big four audit partner was that due to the increasingly complex nature of current financial reporting, there is a lack of general understanding over the information reported in the back-half of the annual report, and therefore more emphasis has been placed on the narrative reporting in the front-half of the annual report. Investors have expressed a strong appetite for the proposal of providing greater assurance over the narrative section of the annual report. Three alternative forms of assurance were suggested in the ICAS research publication Meeting the needs? along the following lines:
Consistency – that the narrative information in the annual report is consistent with the other qualitative and quantitative information that the auditor has acquired during the course of performing the audit.

Process – that the processes and procedures established to produce narrative information are designed and function appropriately to ensure that this information is ‘balanced and reasonable’.

Content – that the management commentary is ‘balanced and reasonable’.

Of these three alternatives, the ICAS ‘Future of Assurance’ Working Group recommended that assurance be provided on the content of the management commentary on a ‘balanced and reasonable’ basis by the auditor.

1.2 Why a ‘balanced and reasonable’ opinion?

The ICAS ‘Future of Assurance’ Working Group believed that the auditor should be capable of providing assurance over the front-half of the annual report. However, they did not believe that this assurance would form the same basis as that provided over the financial statements i.e. ‘true and fair’. In their opinion, ‘true and fair’ is synonymous with the historic financial statements and this type of opinion, which is enshrined in UK Company Law, would not transfer easily to assurance provided on any other areas of the annual report, the content of which is far more qualitative in nature.

Therefore, the Working Group devised the ‘balanced and reasonable’ opinion based on their perception and understanding of what would be useful to users. This is important as users are ultimately the recipients of such reports. Users were also represented on the Working Group.

Balanced

In the case of ‘balanced’, this term was chosen to emphasise that the views expressed by company officers should reflect a realistic perspective of the business and not be subject to ‘spin’ or ‘bias’ – in particular to avoid the situation where the directors ‘cherry pick’ the information reported/provided and focus on promoting mainly the positive aspects of the company’s performance.

Reasonable

The word ‘reasonable’ was chosen to highlight that the auditor would need to ensure that the views expressed by the company’s officers were appropriate, based on the information available at the time, and that a similarly skilled professional would have considered the information to be truthful and honestly expressed, and that any assumptions and judgements made by the directors were sensible and justifiable in the circumstances. The auditor would also need to ensure that, given the current and expected future performance of the company, the information disclosed was complete in that all important information was provided, and was consistent with the view given by the financial statements.
Specific question:

(i) Do you agree that users need assurance over the front-half of the annual report? If yes, do you believe that the proposed ‘balanced and reasonable’ opinion, supported by an appropriate framework based on the guidance in this paper, will meet users’ needs?

1.3 Current position

As stated earlier, until recently in the UK, the only requirement on the part of the auditor, in relation to the information contained in the management commentary, was to ensure that this was free from significant misstatements or inconsistencies with the financial statements. The FRC, however, issued a revised ISA (UK and Ireland) 720 recently, applicable for accounting periods commencing on or after 1 October 2012, which has extended the scope of this consistency check. For periods thereafter, the auditor is now required to also read the other information contained in the annual report to identify any information that is apparently significantly incorrect based on, or significantly inconsistent with, the knowledge acquired by the auditor in the course of performing the audit.

Furthermore, the FRC published a discussion paper Effective Company Stewardship Next Steps in September 2011. This report favoured more emphasis on the part of the auditor over the narrative information contained in the annual report. Subsequently, in April 2012, the FRC issued a consultation paper which proposed that auditors be asked to opine, on an exception basis, as to whether a company’s annual report was fair, balanced and understandable, i.e. the auditor would only report where the annual report was not believed to be ‘fair, balanced and understandable.’ This FRC proposal became applicable for accounting periods commencing on or after 1 October 2012 and can be found in the revised ISA (UK and Ireland) 700 The Auditor’s Report on Financial Statements. Where the auditor has nothing to report by exception he is required to state: “We have nothing to report...” or wording to that effect.

The ICAS Working Group preferred the use of the term ‘reasonable’ as opposed to ‘fair’ to ensure a clear distinction between this opinion and that of the ‘true and fair’ opinion on the financial statements. Additionally, the Working Group favoured the expression of a clear positive opinion rather than being required to report by exception. Such reporting by exception is opaque, not well understood by the user and is confusing as to the degree of assurance which is provided.

It is for debate whether the expression of a ‘balanced and reasonable’ opinion is the correct one at this stage, or if the FRC’s ‘fair, balanced and understandable’ opinion is more appropriate. Perhaps it is a reference by the auditor stating that he/she “...has nothing to report...” along the lines of the FRC’s proposal in the revised ISA 700 that should be seen as the most feasible initial objective for providing assurance on the management commentary. Ultimately, however, we believe that the final objective should be the provision of a positive opinion on management commentary.

1.4 Assurance and expression of opinion

Under the IAASB’s framework for assurance engagements, there are only two types of such engagements which are defined as follows:

(i) Reasonable assurance engagement:

The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement,
as the basis for a positive form of expression of the auditor’s conclusion.

(ii) Limited assurance engagement:
The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the auditor’s conclusion. As a result, the extent of testing for a limited assurance engagement will be less than that required for a reasonable assurance engagement. The auditor expresses his opinion in a negative form. This negative assurance has the form of a double negation (‘nothing has come to our attention to believe that... is not...’).

Assurance perceived

The conclusions from the ‘Future of Assurance’ Working Group did not go so far as to define the type of assurance that could be expressed on the narrative information, that is, whether ‘reasonable assurance’ or ‘limited assurance’ could be provided. However, the Group’s vision was that a meaningful opinion should be provided on the front-half of the annual report as to whether the ‘story’ presented in the management commentary was ‘balanced and reasonable’, i.e. a positive opinion. They were also cognisant of the fact that users are more comfortable with the expression of a positive opinion and see value in an opinion of this nature. A negative assurance opinion is viewed as confusing, offering less value to users, and is seen in some quarters as being the adoption of a rather defensive approach by the profession.

Content of FTSE 350 annual reports

In relation to the content of typical FTSE 350 annual reports, there are areas within such reports over which ‘reasonable assurance’ could more easily be provided. For example, details of environmental performance, market position and industry development should be capable of being supported by either the auditor’s knowledge of the entity or corroborating external evidence from a 3rd party or expert. Further guidance on the level of assurance that could be expressed over other key areas of the narrative information is offered in section 3 of this paper. However, there is traditionally some content found in such reports, for example, completeness of key stakeholders’ interests and concerns and future prospects and financial outlook (see section 3), over which it may be considered more difficult to provide positive assurance. That does not mean to say that the barriers are insurmountable, but one does need to recognise that they exist.

Positive or negative opinion

Although the ‘Future of Assurance’ Working Group preferred the expression of a positive opinion within an assurance report, there is concern that, for certain narrative disclosures, such as future prospects and outlook, the nature and extent of some of the assurance may need to be explained or restricted in some way to reflect the inherent inability to predict the future. This is certainly the view taken by the South African Institute of Chartered Accountants (SAICA) who, in their discussion paper on the Framework for Integrated Reporting, stated that “Assurance cannot generally be expressed on prospective and future information; however, organisations can obtain assurance on the processes and assumptions leading to forward-looking statements”.

We take a different view, and seek an approach which requires at its heart a fundamental reassessment of the existing IAASB assurance framework. Having suggested the idea of a new assurance framework, this paper seeks to consider the procedures to be undertaken...
which would allow an auditor, through use of professional judgement, to provide a positive opinion, in ‘balanced and reasonable’ terms. There needs to be an acceptance that the auditor bases his judgement on the information available at a point in time. The assumptions underlying such future-oriented information should be clearly set out by the directors and a statement referring to the inherent uncertainty of certain information should be included in the scope of the auditor’s ‘balanced and reasonable’ opinion.

Looking to developments elsewhere, in Germany, auditors are required to provide reasonable assurance over the ‘combined management report’. This illustrates that it appears that it is possible to provide a positive opinion over management commentary. The opinion paragraph in such audit reports states that the ‘combined management report’ provides a ‘suitable view of the Group’s position and suitably presents the opportunities and risks of future development.’ In the examples which we have looked at, none of the auditor’s reports contained any modifications or disclosures of limitations or even key assumptions, but their inclusion may still be possible and/or appropriate to fulfil users’ expectations, whilst giving the auditor a degree of comfort over the extent of their responsibilities and potential liability. We have only made reference to the English language version of these audit reports and therefore are unable to comment on whether the actual original German version is restricted in scope in relation to some of the content of the combined management report.

In addition, the recent IAASB statement ISAE 3410 Assurance Engagements on Greenhouse Gas Statements, includes examples of assurance reports which provide either ‘reasonable’ or ‘limited assurance’. The report providing ‘reasonable assurance’ does however contain a disclaimer over the inherent uncertainty of certain scientific knowledge. Could ‘reasonable assurance’ therefore be achieved by including such a disclaimer, referring to the inherent uncertainty of future-oriented information, within the assurance report on management commentary?

In fact, AT Section 701 of Statement of Standards for Attestation Engagements (SSAE) 10 on Management’s Discussion and Analysis (MD&A), prepared by the American Institute of CPAs (AICPA), offers guidance to AICPA members undertaking an examination of the content of an MD&A and suggests the inclusion of a paragraph emphasising the unpredictability of future events and their anticipated impact.

In the light of these developments, we would like to challenge the IAASB’s Framework for Assurance Engagements as being too restrictive, based on only two levels of possible assurance. Indeed, consideration has to be given as to whether it would be better to expand this to three tiers of assurance along the lines of the following:
<table>
<thead>
<tr>
<th>Level of assurance</th>
<th>Description</th>
<th>Examples</th>
<th>Nature of opinion</th>
<th>Nature of work</th>
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<tbody>
<tr>
<td>High</td>
<td>Assurance where the majority of information is capable of being externally and/or objectively verified.</td>
<td>Financial statement items and disclosures, and narrative disclosures which are objectively verifiable or 'auditable'.</td>
<td>Positive.</td>
<td>Developing and undertaking tests and procedures. Responding to the assessed risks that the information disclosed is not independently or objectively verifiable.</td>
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<tr>
<td>Medium</td>
<td>Assurance where in certain areas no sufficient, appropriate external evidence is available but the auditor is able to exercise professional judgement.</td>
<td>Future-oriented information.</td>
<td>Positive, possibly with a disclaimer relating to the inherent uncertainty of some types of information.</td>
<td>Assessment based upon knowledge of the business and professional judgement over the reasonableness of the future-oriented information available at the time.</td>
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<tr>
<td>Low</td>
<td>Generally, assurance where there is nothing to indicate that the information in the management commentary is not in accordance with the relevant framework.</td>
<td>Review engagement.</td>
<td>Generally expected to be negative.</td>
<td>Consists mainly of enquiry and analytical procedures.</td>
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</table>

The above table represents the application of a risk-based approach to an assurance engagement.

**Specific questions:**

(ii) Should further consideration be given to redefining the terms ‘reasonable assurance’ and ‘limited assurance’ within the IAASB’s current assurance framework, or should consideration be given to the introduction of a three-tier system of assurance using the terms ‘high’, ‘medium’ and ‘low’? Do you have any alternative suggestions?

(iii) Do you have any suggestions as to how the levels of assurance might be measured or defined?
1.5 Upcoming key developments

IAASB

The IAASB issued an Invitation to Comment (ITC) on the future of auditor reporting at the end of June 2012. The consultation period closed on 8 October 2012. Part of the IAASB’s ITC contained an illustrative example of what they perceived an improved auditor’s report would look like. The improvements suggested by the IAASB for the auditor’s report were:

- highlighting important matters of judgement;
- a statement on the appropriateness of management’s going concern assessment;
- a more prominent position for the opinion paragraph; and
- highlighting any inconsistencies between the financial statements and other information, with the other information specifically identified.

In November 2012, the IAASB issued an Exposure Draft proposing amendments to ISA 720: The Auditor’s Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor’s Report Thereon. The proposals required the auditor to consider other information acquired during the course of the audit and to respond, as appropriate, when a material misstatement or inconsistency arose in that information. This proposal aligned the IAASB thinking with that of the FRC, who issued revised ISA 720 (UK and Ireland) requiring similar considerations in October 2012.

European Union (EU)

The European Commission (EC) published its proposals in late 2011 for an expanded audit report and a long-form audit report. These proposals are currently being considered by the Council of Ministers and the European Parliament. There was no proposal from the EC for the auditor to be asked to provide assurance over the front-half of a company’s annual report.

However, at the time of writing, an amendment has been proposed to the Accounting Directives in the European Parliament in relation to the assurance to be provided on the management commentary. The wording of this amendment is as follows:

‘The statutory auditor shall also report concerning:

(a) the consistency of the management report with the financial statements for the same financial year;
(b) whether the management report has been prepared in accordance with the applicable legal requirements; and
(c) whether according to the auditor’s knowledge and understanding of the undertaking and its environment obtained during the course of the audit, the management report as a whole suitably presents the undertaking’s position, the opportunities and principal risks and uncertainties of its likely future development.’

This proposed amendment would appear to be in line with the current requirements in Germany, mentioned earlier.

FRC

As noted above, the FRC has increased the role of the auditor in relation to the narrative section of the annual report. In the recently revised ISA (UK and Ireland) 700, it now requires
at paragraphs 22A and 22B respectively:

“In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code or to explain why they have not, the auditor shall report by exception if, when reading the other financial and non-financial information included in the annual report, the auditor has identified information that is materially inconsistent with the information in the audited financial statements or is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit or that is otherwise misleading.”

Matters that the auditor shall report on by exception in accordance with paragraph 22A, comprise circumstances where the annual report includes:

“A statement given by the directors that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity’s performance, business model and strategy, that is inconsistent with the knowledge acquired by the auditor in the course of performing the audit.”

International Integrated Reporting Council (IIRC)

The King III Corporate Governance Code in South Africa requires listed companies to produce an integrated report, or explain why they have not done so. The Code also suggests that audit committees should recommend to the board the appointment of ‘an external assurance provider on material sustainability issues’. Interestingly, it is ‘limited assurance’ that has been provided on such integrated reports produced to date. In addition, statements detailing the scope of the subject matter, procedures selected and any limitations have been included in these assurance statements.

The IIRC is currently developing an Integrated Reporting Framework to assist in the Integrated Reporting process and is expected to be the point of reference when preparing an Integrated Report. Version 1.0 of this framework is likely to be consulted on in Spring 2013 and a finalised version issued in late 2013.

As part of this process, The Independent Regulatory Board of Auditors (IRBA) South Africa, is leading a project to consider the provision of assurance on integrated reports. A consultation paper on assurance is expected to be issued during 2013.

1.6 Scope of the opinion

The scope of the opinion is obviously a very contentious issue. It would not appear feasible for the ‘balanced and reasonable’ opinion to be open-ended and a framework therefore needs to be established. Having given great consideration to this matter, we have concluded that the scope should be in line with the FRC’s requirement in the revised ISA (UK and Ireland) 720, but also recognise the possibility of greater knowledge being acquired by the auditor during the assurance engagement being performed on the management commentary i.e. it should be based on the knowledge acquired by the auditor in the course of performing the audit and the specific assurance engagement on the narrative information.
Specific question:

(iv) Do you agree that the basis for the auditor’s ‘balanced and reasonable’ opinion on the management commentary should be limited to knowledge of the entity and the business environment, acquired by the auditor in the course of performing the audit and the specific assurance engagement on the management commentary, and not extended to include broader knowledge of the entity and the business environment?

1.7 Broader utilisation

If a suitable approach can be developed for the expression of a positive ‘balanced and reasonable’ opinion on the front-half of the annual report, it is anticipated that it could also be applied to other reports which contain a variety of different types of information, such as integrated reports.

Integrated Reporting (IR) brings together material information about an organisation’s strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which the entity operates. It has been suggested that such reports may only be perceived as having any value to users if external assurance is provided. It is hoped that with minimal adaptation, this paper could be used as guidance for the application of such assurance.

It is also anticipated that the proposals set out in this paper could be applied to other reports containing narrative information, financial and non-financial information, KPIs, regulatory information and future-oriented information.

1.8 Assurance provider

The paper has been presented on the basis that the assurance to be provided on the management commentary will be provided by the auditor of the organisation concerned. Whilst in our view this would appear to be the most pragmatic and cost efficient means of doing so, such an assurance engagement could possibly be provided by another professional accountancy firm, other than the auditor.

Specific question:

(v) Do you believe that the approach advocated in this paper could be adapted to provide a positive assurance opinion on integrated reports and other narrative engagements?
2 BALANCED AND REASONABLE – WHAT WOULD BE REQUIRED?

2.1 Definitions

The definitions of ‘balanced’ and ‘reasonable’ as per the ICAS ‘Future of Assurance’ Working Group are summarised at paragraph 1.2

Other definitions include:

<table>
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<th>Balanced</th>
<th>Reasonable</th>
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<td>- Unbiased; fair; neutral; open-minded; detached; equitable (the free dictionary).</td>
<td></td>
</tr>
<tr>
<td>- Keeping or showing a balance; taking everything into account; fairly judged or presented, stable (Oxford English dictionary).</td>
<td></td>
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<tr>
<td>- Free from favouritism or self-interest or bias; logical; consistent; rational; valid; not excessive or extreme; being within reasonable or average limits (the free dictionary).</td>
<td></td>
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<tr>
<td>- Having sound judgement; fair and sensible; based on good sense; able to think, understand, or form judgements by a logical process; as much as is appropriate or fair; moderate; fairly good; average (Oxford English dictionary).</td>
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Undoubtedly, the process for assessing the nature and extent of the narrative information will be more subjective than the process followed during a financial statement audit engagement. The following guidance, in our view, may be helpful when considering whether the information reported can be considered ‘balanced and reasonable’:

- Free from bias
  The auditor needs to be satisfied that the management commentary is not subject to management ‘spin’ and seeks to create a more favourable impression of the company’s position and future prospects than is warranted. Important bad news should be highlighted and discussed in the same way as important good news!

- In line with expectations
  The management commentary should present and disclose the relevant information the auditor would have expected to see. For example, when reviewing the management commentary you would expect to see a reference to any significant events which have occurred during the year as part of the business review.

- Material and ‘significant’
  In assessing the reasonableness of the management commentary, the auditor needs to consider the criteria for inclusion of information therein. A definition is currently provided for materiality in relation to information contained in the financial statements. Information is material to the financial statements "if its misstatement or omission might reasonably be expected to influence the economic decisions of users". Therefore, all material information should be included in the financial statements.

The management commentary cannot rely on the principle of materiality as defined for the financial statements as this would lead to duplication of much of the information.
already presented. It will therefore be necessary to apply a different principle in relation to the content of management commentary to ensure that all important information is included and discussed. In order to draw a clear distinction from the principle applied to material information in relation to the financial statements, our proposal, for the purposes of this paper, is to replace the reference to material information, with a new definition of ‘significant’ information to be associated with information important enough to be included in the management commentary. We define ‘significant’ information in this context as: “information which is pervasive or fundamental to an understanding of the performance, position and prospects of the company, the omission or misstatement of which, would be expected to influence the assessment made by users.” Full definitions of ‘material’ and ‘significant’ are included in the table at Appendix 3.

The use of professional judgement will also be required when determining whether information is ‘significant’ and should be included in the management commentary. The application of this judgement will involve consideration of the consequences of disclosure or non-disclosure of certain elements of information and whether this will have a ‘significant’ impact on users’ understanding and their future decisions.

It is interesting to note that the recently issued Integrated Reporting Background Paper on Materiality from the IIRC/AICPA uses the same term (‘materiality’) but redefines it for the purposes of an integrated report – so that for the purposes of Integrated Reporting (IR), it should be based upon whether information could substantively influence an evaluation of the organisation’s ability to create value over the short, medium and longer term. The key criteria for assessing such materiality have been identified as ‘relevance’ and ‘importance’, with the latter being considered in terms of magnitude (with both quantitative and qualitative considerations) and likelihood (where there is a degree of uncertainty involved).

- **Consistency**
  A critical part of the ‘reasonableness’ assessment is whether the management commentary is consistent with the information contained in the financial statements and with the auditor’s understanding of the organisation and its business.

- **Professional judgement**
  The management commentary will necessarily include disclosures based upon management assumptions and determinations which may not be capable of being externally verified. In considering such assumptions, the auditor would need to assess the underlying information on which these assumptions and determinations have been based and discuss the conclusions drawn with the directors. In the likely absence of any hard evidence, concluding as to whether the directors’ judgements are ‘balanced and reasonable’ will require a substantial amount of professional judgement to be exercised by the auditor.

- **Forward-looking information**
  There is likely to be some resistance to the suggestion that a positive opinion could be provided which encompasses forward-looking information, on the basis that much of it is not capable of being externally verified and may be subject to a substantial amount of uncertainty. However, much of the information on which the auditor currently relies is not capable of being externally or objectively verified and relies on the auditor’s ability to apply professional judgement as referred to above. It should also be noted that many of the more risky judgements within the financial statements are currently based on forward-looking assumptions e.g. impairments, level 3 financial instrument valuations, pension liabilities and provisions. It should also be made clear that the
auditor’s assessment of whether the forward-looking information is ‘balanced and reasonable’ is based upon the information available at the time, and that the auditor cannot be held to account for not having the advantage of hindsight. A statement to this effect has been suggested for inclusion in the example of a clean assurance report (see Appendix 2).

• Content

The content of the management commentary should include ‘significant’ information and be tailored specifically to the reporting entity to avoid becoming boilerplate. It may be expected to include, amongst other information: management’s description of the reporting entity’s activities, competitive position, business model, business drivers, strategy, risks and key areas of judgement. Auditors would be expected to consider whether there has been adequate reference and mention within the management commentary of the effect that the business model and strategy is likely to have on the reporting entity’s balance sheet and future economic value.

Specific questions:

(vi) Do you consider that the term ‘balanced and reasonable’ is the appropriate form of opinion to be expressed over management commentary, or do you believe that the opinion expressed should be limited to reporting on an exception basis, where the narrative information is not considered to be ‘fair, balanced and understandable’? Reference should be made to the definitions of ‘balanced’ and ‘reasonable’ in section 2.1 when preparing your response.

(vii) Do you agree with the proposed substitution of the word ‘significant’ for the word ‘material’ to draw a clear distinction between what should be included in the management commentary from the familiar reference to material information which is specific to information presented in the financial statements? Do you have any alternative suggestions for a term that would be an appropriate substitute for ‘material’ in relation to information that would be considered important in the management commentary?

2.2 Extent of work required

Related standards currently available

There is existing material available in relation to other assurance engagements that could be applied in an assurance engagement on management commentary. The IAASB has produced an International framework for assurance engagements which is a starting point when considering the approach that would require to be adopted to enable a ‘balanced and reasonable’ opinion to be delivered.

International Standard on Assurance Engagements (ISAE) 3000, Assurance engagements other than audits or reviews of historical information, follows on from the framework and its purpose is to establish basic principles and essential procedures for, and to provide guidance to, professional accountants in public practice for the performance of assurance engagements other than audits or reviews of historical financial information covered by ISAs or International Standards on Review Engagements (ISREs). ISAE 3410, Assurance Engagements on Greenhouse Gas Statements, falls under the umbrella of the aforementioned standard and an ISAE 3410 engagement must also comply with the requirements of ISAE 3000.
AccountAbility’s AA 1000 Assurance Standard 2008 focuses on assurance over sustainability information. Although not specifically referred to below, AA 1000 may offer certain insights to an auditor undertaking an assurance engagement on management commentary, particularly where sustainability information is involved.

Using the above, as well as the current ISAs (UK & Ireland), we can set out the extent of additional procedures we believe would be required for an assurance engagement on management commentary and how this relates to the work currently being performed to comply with the requirements of a financial statement audit engagement. For the purposes of this paper, we will refer to an assurance engagement on management commentary simply as an assurance engagement.

Procedures for providing a ‘balanced and reasonable’ opinion

Step 1  Accepting the engagement (including ethics, quality control, terms of engagement)

Procedures followed as part of the statutory audit process using ISA 210 Agreeing the terms of audit engagements and ISA 220 Quality control for an audit of financial statements will be sufficient here. In relation to independence requirements for an engagement of this type, we are making the assumption that compliance with the International Ethics Standards Board for Accountants (IESBA) Code of Ethics would be required (auditors in the UK would of course need to comply with the requirements of the Auditing Practices Board’s (APB) ethical standards for auditors). We anticipate that the service to be provided would be viewed as an audit related assurance service and not provide any additional independence threats to the auditor of the entity, should that same firm undertake this type of assurance engagement.

A separate engagement letter may be required which sets out the scope of the assurance engagement and the nature of the opinion. The auditors may be able to limit their liability on such engagements, even if this is not possible for the financial statement audit. If a separate engagement letter was not issued then the existing financial statement audit engagement letter would require to be revised to incorporate the changes to the scope of the assignment.

The skills and expertise of the engagement team will need consideration and, specifically, provisional consideration given to whether any specialist external experts should be engaged. The firm will of course need to consider whether it has or can gain the necessary skills to undertake such an assurance engagement.

Step 2  Scope of engagement

The scope needs to be given careful consideration and appropriately detailed in the terms of the assurance engagement. Therefore, clear boundaries and expectations need to be agreed and documented when the engagement is accepted. Any limitations on the extent of information over which assurance will be provided, as well as key management assumptions, should be agreed and documented at the planning stage, as detailed in step 3 below.

Step 3  Planning (including gathering knowledge of the entity and the environment in which it operates)

Procedures for gathering knowledge of the entity undertaken during the audit process, as required under ISA 315 Identifying and assessing risks of material misstatement through understanding the entity and its environment, should be sufficient for an assurance engagement and there should be no significant additional onerous procedures required. However, the auditor may need increased access to information and operational staff members, in order to enhance his/her knowledge of all the operations and systems within the organisation as part of the preparation of a comprehensive risk assessment and the
acquisition of a broader understanding of key assumptions and specific techniques applied. At this stage, the auditor will determine whether he/she will require to engage any external experts or 3rd party professionals on whose expertise he/she will rely to acquire sufficient and appropriate evidence on which to base his/her opinion, including whether and to what extent the work of the internal audit function of the entity (if one exists) shall be relied upon (subject to appropriate review on some of the work it performs).

The level of professional scepticism required for undertaking the audit will be satisfactory for undertaking the assurance engagement. Audit firms will need to be mindful that they will possibly have to widen their respective skill sets to allow them to undertake an assurance engagement, as the subject matter will be wider and the degree of professional judgement greater. Where any shortage of experience or expertise is identified, this would normally lead to the need to involve external specialists or the auditor having to decline the particular engagement.

**Step 4  Risk assessment and response to identified risks**

ISA 315 and ISA 320 *Materiality in planning and performing an audit* give sufficient guidance on the approach to the risk of a material misstatement in an assurance engagement. These principles will be relevant for the assurance engagement, however, as discussed in section 2.1, we propose to substitute the reference to ‘material’, as included in the ISAs, with a new reference to ‘significant’.

As a result, from the knowledge acquired of the entity, the auditor can prepare a risk assessment of the internal and external risks facing the organisation, highlight those areas with a ‘significant’ risk of ‘significant’ misstatement and develop an expectation of the information that should be reported. In particular, the auditor has to consider whether there are any risks which would not impact on the potential truth and fairness of the financial statements, but might impact on the additional assurance that they will be providing on the entity’s management commentary e.g. is the business model accurately described?

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of ‘significant’ misstatement which should incorporate consideration of inherent risk, control risk and detection risk. The auditor shall exercise professional judgement when assessing the risk of ‘significant’ misstatement in the key assumptions and estimates made by management and included in the management commentary. As a result, some of the evidence from which this information is derived is likely to be persuasive in nature. In accordance with ISA 330 *The auditor’s responses to assessed risks*, the auditor shall design and implement responses to the risks of ‘significant’ misstatement identified and assessed by the auditor in accordance with the requirements of ISA 315.

**Step 5  Subject matter and criteria**

The information in the management commentary should be ‘balanced and reasonable’. The requirements of ISA 320, in relation to the financial statement audit process, will be sufficient for an assurance engagement, although some of the content contained in the front-half of an annual report will be more persuasive in nature than that which would be required in relation to the expression of a financial statement audit opinion. This does not distract from the need for the auditor to exercise appropriate professional scepticism and judgement.
Step 6  Evidence

As per ISA 500 Audit evidence, evidence should be sufficient and appropriate both in terms of quantity and quality. The importance of exercising professional scepticism during both the planning and the execution of an assurance engagement is vital (see Step 3 above). As stated in Step 5, it is envisaged that certain content of the annual report will not be capable of being supported by external corroborative evidence. Such content will be based upon estimates and assumptions made by management, the reasonableness of which will be assessed by the auditor exercising his/her professional scepticism and judgement.

Step 7  ‘Significant’ information

As stated in ISA 315 and ISA 320, the auditor considers and assesses the factors that may result in material misstatement. As stated in Step 4, for the purposes of this paper, ‘material’ has been replaced by the term ‘significant’, as detailed in section 2.1. Such information of course also needs to be considered in its qualitative context and not simply focus on the quantitative aspects. A ‘significant’ misstatement is one whose omission or inaccuracy would most likely influence the decision of an intended user. The auditor will rely upon his/her knowledge of the entity to determine those areas more at risk of ‘significant’ misstatement.

Step 8  Using the work of an expert (including internal audit)

Given the nature of the content within the front-half of many annual reports, this may become an even more important consideration for auditors, as they are faced with providing assurance in areas beyond their normal comfort zones. Due to the tight deadlines for issuing annual reports and related assurance, care will need to be taken to ensure that any experts required are engaged early to minimise any risk of a delay in the publication process. The auditor also needs to satisfy himself/herself as to the suitability and competence of the expert and that the expert’s work is adequate for the purpose that is intended.

If the organisation has an internal audit function, and the auditor intends to rely, subject to appropriate review, on some of the work it performs, this should be documented and agreed at the planning stage of the assurance engagement.

Step 9  Reporting

The proposed expression of opinion is a positive one, concluding whether or not the management commentary is ‘balanced and reasonable’: the additional opinion will provide assurance that the management commentary is free from bias and provides sufficient disclosure of what the auditor considers to be ‘significant’ information. Many of the conclusions drawn by the auditor in relation to what is ‘balanced and reasonable’ will be based upon professional judgement.

As the auditor is using ‘significant’ as opposed to ‘material’ as the basis for assessing the impact of any misstatements etc. and determining whether a clean assurance report can be issued, this removes the possibility of the issuance of a qualified opinion. Adverse opinions and disclaimers of opinion however will still be relevant for the new ‘balanced and reasonable’ opinion. The process for determining what is likely to result in an adverse opinion or a disclaimer of opinion may be more subjective than the process followed during a financial statement audit engagement, due to the more qualitative nature of the engagement.
Clean opinion

The auditor shall express a clean opinion when:

- Sufficient, appropriate evidence has been obtained which confirms that the disclosures within the management commentary are considered to be ‘balanced and reasonable’; or
- Insufficient, appropriate evidence is available but based on the auditor’s professional judgement, disclosures within the management commentary are considered to be ‘balanced and reasonable’.

Disclaimer

- The auditor shall express a disclaimer of opinion when the possible effect on the management commentary, due to the lack of sufficient, appropriate evidence or the inability to exercise professional judgement, in situations of severe uncertainty, is so ‘significant’ that the auditor is unable to express a clean ‘balanced and reasonable’ opinion.

Adverse opinion

- The auditor shall express an adverse opinion when, having obtained sufficient, appropriate evidence, concludes that misstatements or omissions, individually or in the aggregate, are ‘significant’ to the management commentary.
- In the absence of sufficient, appropriate evidence but, having considered the reasonableness of the directors’ judgements and opinions, the auditor concludes that information is included in the management commentary which is unreasonable or unbalanced/biased, individually or in aggregate, such that it distorts the management commentary in a ‘significant’ manner.

The flowchart in Appendix 1 provides a guide ‘to be referred to’ when determining the nature of opinion to be issued and illustrates the thought process to be followed.

An example of a proposed assurance report containing a clean opinion is included at Appendix 2.

Impact of the auditor having issued a qualified opinion on the financial statements

In the event that the auditor has issued a qualified opinion on the financial statements, whether this will result in the need to issue a disclaimer or adverse opinion on the management commentary will be based on whether the auditor considers that the nature of the qualification on the financial statements is likely to have a ‘significant’ impact on the management commentary i.e. that it would result in the management commentary not being ‘balanced and reasonable’.

For example, if the audit qualification in the financial statements is on the basis of a disagreement with management over the accounting treatment of a specific matter, the impact on the management commentary may not be so ‘significant’ that it necessitates a modified opinion on the management commentary.

However, if the auditor has issued a disclaimer of opinion on the financial statements i.e. where the auditor is unable to give an opinion on whether the financial statements are true and fair, this in all probability is more likely to impact the type of opinion expressed on the management commentary.
Specific questions:

(viii) What level of additional costs would you expect to be incurred by the auditor in providing assurance on management commentary?

(ix) Is the benefit to users from this new opinion likely to exceed the cost of this additional work?

(x) Do you believe that auditors would be willing to express a positive opinion on management commentary, in particular over future-oriented information, which relies so heavily on their professional judgement? Do you believe that some form of caveat or disclaimer within the assurance opinion would be necessary to enable auditors to provide a positive opinion on a narrative report encapsulating future-oriented information?

(xi) Do you believe that auditors are the most appropriate and suitably qualified professionals to undertake an assurance engagement on the management commentary? Do you believe that there is likely to be any conflict of interest or perceived threat to auditor independence if the statutory audit and this type of assurance engagement are undertaken by the same audit firm?

(xii) Do you envisage resistance from management/those charged with governance, from disclosing information relating to an entity’s business model due to concerns over the confidential and sensitive nature of this information?

(xiii) Have we identified the appropriate additional procedures in section 2.2 which an auditor would need to undertake to give a ‘balanced and reasonable’ opinion on the narrative section of the annual report?

(xiv) Do you agree that the content in section 2.2 is the most relevant and appropriate to be considered when undertaking this type of assurance engagement?

(xv) Do you believe that the proposed modifications to the assurance report in Step 9 of section 2.2, and the flowchart within Appendix 1 are adequate and provide a clear means for determining the nature of the opinion to be expressed?

(xvi) Do you consider that the two conditions listed in Step 9 of section 2.2 for the expression of a clean opinion will cover each of the following three possible scenarios?

- Where sufficient, appropriate evidence is available for the expression of a clean opinion; or
- Where sufficient, appropriate evidence is available to provide a degree of assurance but, in addition, the application of professional judgement will be required to gain sufficient assurance to express a clean opinion; or
- Where there is a lack of, or no, sufficient, appropriate evidence and therefore a clean opinion relies completely on the application of the auditor’s professional judgement.

(xvii) Do you envisage any barriers to the implementation of a ‘balanced and reasonable’ opinion? For example, do you believe that the current liability regime for auditors in your jurisdiction is flexible enough to assign different levels of liability to the different types of engagement?
3 PRACTICAL CONSIDERATIONS

3.1 Content of annual reports – How can positive assurance be provided?

Considering some of the current narrative headings in FTSE 350 annual reports, there follows a suggestion of how the auditor might provide positive assurance over these disclosures.

NB: The suggestions are intended as a guide only and the list includes non-standard disclosures and is not exhaustive. The classification of the individual disclosures will vary from entity to entity and require the application of professional judgement:

Factual and verifiable disclosures:
Disclosures that can be verified to external or other reliable sources

Administrative details of the entity
Organisational structure and statutory information
Group activities
Statements from key management personnel
Segmental performance
Strategy
Investment policy and performance
Company values
Governance and corporate governance statements including Audit Committee; Ethics Committee, Nominations Committee
Board expertise and qualifications
Ethical requirements
Effectiveness of internal controls
KPIs - financial
Remuneration strategy
Financial information (extracted from the financial statements)
Business model
Key accounting policies

Subjective disclosures:
Disclosures for which there may be little or no corroborative, supporting evidence, and which requires application of management judgements and assumptions - over which the auditor will have to exercise professional judgement

Key achievements/failures
Measurement of performance against goals and objectives
Addressing concerns of key stakeholders
Significant judgements
Financial information (not extracted from the financial statements)
Statement of compliance with company values
Attitude to risk
Risk mitigation
KPIs non-financial
CSR & Sustainability (including Health & Safety)
Ethics
**Information which is uncertain and unpredictable:**

Information regarding future prospects and outlook will be subject to a lesser degree of assurance and may require a reference within the assurance report, due to the unpredictable nature of future-oriented information. A further statement may be required that the assurance provided has been based on the most accurate information available at the time, to ensure that the assurance provider cannot be held to account for not having the benefit of hindsight.

**Specific question:**

(xviii) Are the practical considerations included in section 3 helpful when assessing how a positive opinion can be provided over the specific disclosures within the management commentary?
4 CONCLUSIONS

4.1 Need for assurance

It is hoped that this paper will launch a debate on the suggestion that the auditor should and could provide a positive opinion on management commentary.

As stated in the introductory paragraphs, there has been both admission and acceptance amongst the profession that a change is needed to the way in which assurance is currently provided, to regain users’ confidence and deliver the additional assurance they need.

The development of Integrated Reporting (IR), may mean that, in the future, much more management emphasis and user attention is given to the integrated report, and this may come to replace some, or all, of the front-half of the annual report. Auditors need to be willing and ready to adapt accordingly. By preparing now for the suggestion that they can and should provide assurance over the management commentary, auditors will be in a better position to react to the additional responsibilities required under Integrated Reporting (IR), when it is introduced.

4.2 Responses

We would welcome comments on this discussion paper from all stakeholders including auditors and regulators; preparers; those charged with governance; and investors and analysts. It would be helpful if any responses were submitted by 31 October 2013.

Respondents are requested to submit their responses electronically to aadrain@icas.org.uk. Unless requested otherwise, all responses will be considered a matter of public record and will ultimately be posted on the ICAS website unless a specific request is received to the contrary.

Comments and responses received as a result of the consultation process will be considered and help the development of assurance on various types of narrative reports, including integrated reports. We would also hope to publish a concise summary of comments received.

Specific area questions:

(xix) Do you believe that such engagements should be of a voluntary nature or should steps be taken to mandate engagements of this nature?

(xx) Do you agree that the assurance report in which a ‘balanced and reasonable’ opinion is expressed over the management commentary should be a completely separate assurance report from the auditor’s report expressing a ‘true and fair’ opinion on the financial statements?

(xxii) Looking ahead, do you envisage a time when assurance of a ‘balanced and reasonable’ nature might be expressed over the whole of the annual report? This may of course make the expression of a ‘true and fair’ opinion on the financial statements redundant.

(xxii) Do you have any other comments?
5 QUESTIONS

(i) Do you agree that users need assurance over the front-half of the annual report? If yes, do you believe that the proposed ‘balanced and reasonable’ opinion, supported by an appropriate framework based on the guidance in this paper, will meet users’ needs?

(ii) Should further consideration be given to redefining the terms ‘reasonable assurance’ and ‘limited assurance’ within the IAASB’s current assurance framework, or should consideration be given to the introduction of a three-tier system of assurance using the terms ‘high’, ‘medium’, and ‘low’? Do you have any alternative suggestions?

(iii) Do you have any suggestions as to how the levels of assurance might be measured or defined?

(iv) Do you agree that the basis for the auditor’s ‘balanced and reasonable’ opinion on the management commentary should be limited to knowledge of the entity and the business environment, acquired by the auditor in the course of performing the audit and the specific assurance engagement on the management commentary, and not extended to include broader knowledge of the entity and the business environment?

(v) Do you believe that the approach advocated in this paper could be adapted to provide a positive assurance opinion on integrated reports and other narrative engagements?

(vi) Do you consider that the term ‘balanced and reasonable’ is the appropriate form of opinion to be expressed over management commentary, or do you believe that the opinion expressed should be limited to reporting on an exception basis, where the narrative information is not considered to be ‘fair, balanced and understandable’? Reference should be made to the definitions of ‘balanced and reasonable’ in section 2.1 when preparing your response.

(vii) Do you agree with the proposed substitution of the word ‘significant’ for the word ‘material’ to draw a clear distinction between what should be included in the management commentary from the familiar reference to material information which is specific to information presented in the financial statements? Do you have any alternative suggestions for a term that would be an appropriate substitute for ‘material’ in relation to information that would be considered important in the management commentary?

(viii) What level of additional costs would you expect to be incurred by the auditor in providing assurance on management commentary?

(ix) Is the benefit to users from this new opinion likely to exceed the cost of this additional work?

(x) Do you believe that auditors would be willing to express a positive opinion on management commentary, in particular over future-oriented information, which relies so heavily on their professional judgement? Do you believe that some form of caveat or disclaimer within the assurance opinion would be necessary to enable auditors to provide a positive opinion on a narrative report encapsulating future-oriented information?
(xi) Do you believe that auditors are the most appropriate and suitably qualified professionals to undertake an assurance engagement on the management commentary? Do you believe that there is likely to be any conflict of interest or perceived threat to auditor independence if the statutory audit and this type of assurance engagement are undertaken by the same audit firm?

(xii) Do you envisage resistance from management/those charged with governance, from disclosing information relating to an entity’s business model due to concerns over the confidential and sensitive nature of this information?

(xiii) Have we identified the appropriate additional procedures in section 2.2 which an auditor would need to undertake to give a ‘balanced and reasonable’ opinion on the narrative section of the annual report?

(xiv) Do you agree that the content listed in section 2.2 is the most relevant and appropriate to be considered when undertaking this type of assurance engagement?

(xv) Do you believe that the proposed modifications to the assurance report in Step 9 of section 2.2 and the flowchart within Appendix 1 are adequate and provide a clear means for determining the nature of the opinion to be expressed?

(xvi) Do you consider that the two conditions listed in Step 9 of section 2.2 for the expression of a clean opinion will cover each of the following three possible scenarios?

- Where sufficient, appropriate evidence is available for the expression of a clean opinion;
- Where sufficient, appropriate evidence is available to provide a degree of assurance but, in addition, the application of professional judgement will be required to gain sufficient assurance to express a clean opinion;
- Where there is a lack of, or no, sufficient, appropriate evidence and therefore a clean opinion relies completely on the application of the auditor’s professional judgement.

(xvii) Do you envisage any barriers to the implementation of a ‘balanced and reasonable’ opinion? For example, do you believe that the current liability regime for auditors in your jurisdiction is flexible enough to assign different levels of liability to the different types of engagement?

(xviii) Are the practical considerations included in section 3 helpful when assessing how a positive opinion can be provided over the specific disclosures within the management commentary?

(xix) Do you believe that such engagements should be of a voluntary nature or should steps be taken to mandate engagements of this nature?

(xx) Do you agree that the assurance report in which a ‘balanced and reasonable’ opinion is expressed over the management commentary should be a completely separate assurance report from the auditor’s report expressing a ‘true and fair’ opinion on the financial statements?

(xxii) Do you have any other comments?
ENDNOTES

1 Management commentary is a narrative report that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives - Management Commentary, IFRS Practice statement.

2 International Integrated Reporting Council - www.theiirc.org/

3 Can we meet the needs? Auditor views on external assurance and management commentary by Ian Fraser and Jacqueline Pierpoint (2011).

4 Meeting the needs? User views on external assurance and management commentary by Ian Fraser, Jacqueline Pierpoint, Bill Collins and William Henry (2010).


7 AT Section 701 Management’s Discussion and Analysis Source SSAE No.10.

8 IIRC/AICPA Materiality Background Paper for <IR> - www.theiirc.org/resources-2/framework-development/background-papers/


10 ISAE 3000 (Revised) Assurance Engagements other than Audits or Reviews of Historical Financial Information - www.ifac.org/publications-resources/isae-3000-revised-assurance-engagements-other-audits-or-reviews-historical-fi

11 ISAE 3410 includes an explanation of a reasonable assurance engagement and clarification of the criteria on which the auditor has based his/her risk assessment. The standard also sets out how reasonable assurance might be provided on such an engagement. However, in any event the auditor, based on his/her knowledge of the business and professional judgement, should be capable of assessing whether the disclosures are ‘balanced and reasonable’.

12 The use of an external expert in relation to some such disclosures can provide reasonable assurance over this area. Inclusion of the statement on the ‘inherent uncertainty’ of some information within the assurance report may enable positive assurance to be provided over this area of management commentary. However, the auditor, based on his/her knowledge of the business and professional judgement, should be capable of assessing whether the disclosures are ‘balanced and reasonable’.
Balanced and reasonable opinion

Has sufficient appropriate evidence been obtained for agreed areas falling within the scope of the engagement?

Yes

Is the management commentary free from bias and in line with expectations?

Yes

Does the management commentary include all relevant information and is it, to the best of our knowledge, free from ‘significant’ omission?

Yes

Based on the work performed, is the management commentary 'balanced and reasonable'?

Yes

Can professional judgement be exercised over the areas where is there is a lack of sufficient appropriate evidence to substantiate the content?

No

Is the possible effect of the lack of evidence and ability to exercise professional judgement so 'significant' that the auditor is unable to express a 'balanced and reasonable' opinion?

Yes

Is the effect so 'significant' that the auditor concludes that an adverse opinion must be issued?

Yes

ADVERSE OPINION

Yes

ADVERSE OPINION

No

No

No

No

No

No

No

No

No

No

No

No

No

No

No

Yes

DISCLAIMER
APPENDIX 2  EXAMPLE CLEAN ASSURANCE REPORT

Introductory paragraph

We have examined the management commentary of XYZ Company for the year ended 31 December 20XX taken as a whole, included in the company's Annual Report.

Opinion paragraph

In our opinion, the company’s management commentary, in all significant respects, is balanced and reasonable, based on the knowledge acquired in the course of performing our examination of the management commentary and our audit of the company’s financial statements.

Scope

Our examination involves obtaining evidence about the amounts and disclosures in the management commentary sufficient to provide assurance that the management commentary is balanced and reasonable. This includes an assessment on a test basis, of the evidence supporting the amounts and disclosures in the management commentary. Our examination also includes assessing the significant judgements made by management as to the completeness and relevance of information included and the estimates and assumptions that affect reported information.

Our examination acknowledges that actual results in the future may differ significantly from management’s present assessment of information regarding the estimated future impact of transactions and events that have occurred or are expected to occur.

Matters of significant judgement

As part of our examination, we exercise professional judgement and maintain professional scepticism throughout the planning and performing of our work and in the final assessment of the content of the management commentary. We also:

- Use the knowledge we obtained in the course of performing our audit of the financial statements, as supplemented by further assessment and enquiry as appropriate and possible, in order to determine whether the management commentary is balanced and reasonable.
- Evaluate whether the underlying information, determinations and assumptions, from which forward-looking disclosures have been derived, are, in our professional judgement, considered to be balanced and reasonable.
- Evaluate whether management conclusions, particularly those involving a significant degree of professional judgement, as set out in the management commentary are balanced and reasonable.

Respective responsibilities of management and the auditor

Responsibility of management (those charged with governance)

Management is responsible for the preparation of the company’s management commentary. The preparation of the management commentary requires management to interpret the criteria, make judgements as to the relevance of information to be included, and make
estimates and assumptions that affect reported information. Management commentary includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ significantly from management’s present assessment of this information because events and circumstances frequently do not occur as expected.

Auditor’s responsibility

Our responsibility is to express an opinion on the management commentary based on our examination. Our examination of the management commentary included examining, on a test basis, evidence supporting the amounts and disclosures reported. An examination also includes assessing the significant judgements made by management as to the relevance of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides an appropriate basis for our opinion.

Signature

Date
## APPENDIX 3 DEFINITIONS OF MATERIAL AND SIGNIFICANT

<table>
<thead>
<tr>
<th>Terminology</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Reporting: Definition of material(ity)</td>
<td>The Accounting Standards Board’s (ASB) Statement of Principles for Financial Reporting defines materiality as information in the financial statements, the misstatement of which might reasonably be expected to influence the economic decisions of users of those financial statements, including their assessments of management’s stewardship.</td>
</tr>
<tr>
<td>Audit &amp; Assurance Framework: Definition of material(ity)</td>
<td>The IAASB’s framework for the preparation and presentation of financial statements explains that misstatements and omissions are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.</td>
</tr>
<tr>
<td>’Balanced and Reasonable’ Opinion: Definition of significant (information)</td>
<td>This discussion paper substitutes significant for material in the context of narrative reports. Significant information is defined here as important information which is pervasive or fundamental to an understanding of the performance and prospects of the company, the omission or misstatement of which would be expected to influence the assessment made by users.</td>
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