



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

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Our ref: ICAEW Rep 43/08

Your ref:

Steven Leonard  
Financial Reporting Council  
5<sup>th</sup> Floor, Aldwych House  
71 – 91 Aldwych  
London WC2B 4HN

By email

Dear Steve

**THE AUDITOR'S REPORT: A TIME FOR CHANGE?**

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Auditing Practices Board's Discussion Paper, The Auditor's Report: A Time for Change?

Our comments with responses to your questions are attached.

If you have any detailed questions in relation to the response, please do not hesitate to contact me.

Yours sincerely

Sumita Shah  
Manager  
Audit and Assurance Faculty  
T +44 (0)20 7920 8516  
E [sumita.shah@icaew.com](mailto:sumita.shah@icaew.com)



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## **ICAEW Representation**

**ICAEW REP 43/08**

### **THE AUDITOR'S REPORT: A TIME FOR CHANGE?**

**Memorandum of comment submitted in March 2008 by The Institute of Chartered Accountants in England and Wales, in response to the Auditing Practices Board's Discussion Paper, The Auditor's Report: A Time for Change? published in December 2007**

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## INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales welcomes the opportunity to comment on the Discussion paper *The Auditor's Report: A Time for Change?* published by the Auditing Practices Board.

## WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

## MAJOR POINTS

### Closing the expectations gap

4. The APB, in the discussion paper, acknowledges that changes to the audit report over the years have been made to address the “*growing so called ‘expectations gap’*”. Over the years, it has issued proposals for an “expanded auditors report” which was intended to address users’ lack of understanding around the scope and nature of an audit and the responsibilities of directors and auditors. Through the work of the *Audit Quality Forum*, it has become clear that whatever form the audit report has taken over the years, there is still an expectations gap. Although, from the views that we have received, we think that there are now different expectations. Our view is that the APB should now seek to address this expectations gap in other ways rather than through the audit report.
5. In our view, there needs to be some wider research to consider and analyse why this expectations gap still exists. Rather than consider how the audit report should be redrafted each time the issue of the expectations gap arises, our view is that it would be more helpful to consider the following:
  - Users’ understanding the preparation process behind the accounting statements of an organisation:
  - the responsibilities and duties of the directors/shareholders in relation to the accounting statements;
  - what the statutory audit is designed to do;
  - the auditors responsibilities in relation to the statutory audit and the accounting statements;
  - the audit process; and
  - finally the audit report.

## **Dealing with the Companies Act 2006**

6. In 2005, the adoption of ISA 700(revised) was delayed due to several uncertainties, any of which may have caused the APB to issue a further major revision in the short term. Although the uncertainties with respect to the Companies Act 2006 and the issuance of ISAs have been resolved, there is still significant uncertainty over the EU position with respect to auditor reports.
7. Given the impact that any decision by the EU may have on the future wording of audit reports, our preference for the short term is for the APB to pronounce minimum changes to the current audit report in order for it to comply with the requirements of the Companies Act 2006. If the APB does go down this route, then our view is that this should be done as a matter of urgency rather than wait until later in the year.
8. However, we do recognise and agree with many of the limitations of the current audit report as set out in the discussion document. Recognising the importance of the need for a flexible, informative and internationally comparable audit report in the medium term, we believe it is important for the APB to influence international regulators and standard setters so as to achieve these objectives and accommodate the needs of the various stakeholders. In particular, we think it is important for the APB to influence the current debate around ISA 700, especially in the areas of the description of management's and auditor's responsibilities. To this end we encourage the APB to take into account our comments detailed below.

## **Think small first**

9. In our view, there is a marked difference between the needs of a small owner-managed entity and a large entity with many external stakeholders. With such a diverse range of users and stakeholders, the audit report must be inherently flexible. One way to achieve this is by virtue of a "think small first" approach, giving consideration to a simpler version of the audit report for small entities with additional paragraphs for companies whose shareholders require a more comprehensive report or where the responsibilities of the auditors are more complex, for instance in the case of listed company reporting with corporate governance considerations..

## **Responsibilities of Directors and Auditors and other clarity language**

10. Whilst we understand the comments made by stakeholders regarding the length of the current reports and their apparent use of "boiler plate" statements, the original drivers of these statements remain as relevant today as when they were introduced. However, provided that they are available to view elsewhere, in principle we agree that there is no reason why these need to be within the body of the audit report. Careful consideration must however be made of the access to this information. For instance, currently in the UK environment engagement letters and similar documents are invariably private documents and not available to all those who have access to the financial statements. Therefore, unless such information becomes readily available and they are unlikely to do so for the majority of companies within the UK, we currently believe that although these statements do not necessarily have to be within the audit report they do need to be within the overall document containing the financial statements.

## **Bannerman paragraph**

11. We note the APB's comments on the Bannerman paragraph that "*it may be timely to reconsider the need for the 'Bannerman' statement.*" However, our view

remains that audit reports need to include clarification wording about the purpose of the audit report and to whom the auditor owes duties (and also to whom they do not owe a duty) with the wording positioned prominently, towards the beginning of the report. Our original position was backed by advice from leading counsel in 2003 and leading counsel has recently confirmed that this remains extant.

#### **Reporting matters by exception**

12. In a number of places within the discussion paper, there is reference to the inclusion of additional statements, some of which, we are aware, were areas that were debated by the *Audit Quality Forum*. The view of practitioners is that there is more value in reporting matters by exception rather than adding in additional lines which state that, for example, there are no matters to emphasise.

#### **Adequacy of accounting records**

13. In relation to there being a positive statement concerning the adequacy of accounting records, we are aware that again this was a matter that was greatly debated by the *Audit Quality Forum*.
14. In our view there needs to be clarity around the definition of “accounting records”; what is considered to be “adequate” and in whose judgement. The APB will be aware that the ICAEW has issued guidance in this area in the past (FRAG 5/92 *Accounting Records*). We note (paragraph 4.32) that the FRC is considering developing guidance for directors with respect to the provisions of the Companies Act 2006 relating to the directors’ responsibilities for maintaining adequate accounting records. In our view, this guidance should be developed urgently and as a matter of priority and address the definition of adequate accounting records and in whose judgement the definition applies, taking legal advice if necessary to ensure that there is no ambiguity. Our view is that the FRC should also develop guidance for auditors in this area.
15. Notwithstanding the points made in the above paragraph, we do not consider that there is a need to include a positive statement in relation to the ‘adequacy of accounting records’. If auditors form a view that the accounting records are inadequate, then they are obliged, as part of their duties, to report this fact.

#### **Public sector**

16. We would also encourage the APB to consider carefully how it intends to apply the wording of the audit report to the different parts of the Public Sector. It will be aware that there are different reporting requirements often driven by the legislation appropriate to each part of the Public Sector. The APB will need to consider and address the different issues and reporting requirements in the context of the Public Sector.

## APB DISCUSSION QUESTIONS

### **Amending the auditor's report to reflect changes to company law.**

**1. Should the auditor's report, as illustrated on pages 14 to 16, make reference to the directors' responsibility under section 393 of CA 2006 to be satisfied that the financial statements give a true and fair view?**

The objective of setting out the auditors and the directors' responsibilities is to enable the user to understand and appreciate the differences between these with respect to the financial statements. Ideally, the auditor's report should remain just that, and focus on the auditor responsibilities and avoid references to what others are responsible for. However, we do recognise that should disclosure of directors' responsibilities not be made in sufficient clarity elsewhere then the auditor needs to include such references within the audit report.

**2(a). Is it helpful for the auditor's report to describe the auditor's responsibilities under CA 2006 to report certain matters by exception?**

In our view, the only way for users to understand the scope of the auditors work with respect to exception reporting is to clearly set out the scope of reporting on matters by exception. We are also of the view that there are clear benefits in having international consistency.

**2(b) If you believe it is helpful to describe the auditor's responsibilities with respect to matters reported on by exception in the auditor's report, do you also believe that, where appropriate, it would be helpful for the auditor's opinion to explicitly state that there is nothing to report in respect of those matters on which they report by exception?**

No, we do not believe that this would add value to the audit report.

### **Other possible changes to the auditor's report**

**3. Should the auditor's report be split into two parts as envisaged by ISA 700 (Revised)?**

In our view, this helps to clarify understanding so, in principle we agree that this will improve the clarity of audit reports and help with comparability. However, the APB does need to consider the impact of such a change on other non-company audited entities such as charities, pension funds and auditors reports in the public sector.

**4(a). Should the auditor's report describe the directors' responsibilities with respect to the preparation of the financial statements?**

No, for the same reasons stated under question 1 unless such statements about their responsibilities are not made clear elsewhere in the financial statements.

**4(b). If you believe it is necessary for the auditor's report to describe the directors' responsibilities, do you prefer the wording prescribed by ISA 700 (Revised) (Example 1) or would you prefer the wording used in Example 2?**

N/A

**5. Is it necessary for the auditor's report to contain a detailed description of the auditor's responsibilities if such information is publicly available?**

In principle we agree that there is no reason why these need to be within the body of the audit report if the information is publicly available somewhere else. Careful consideration must be given to the access to this information. For instance, currently in the UK environment this information is not readily available to all those who have access to the financial statements.

**6. Should the auditor's report refer to the auditor's responsibility to comply with APB's Ethical Standards?**

No, in our view, the ethical standards are part of the completed ISAs (UK and Ireland) (ISA (UK and Ireland) 200 requires compliance with the Ethical Standards) and therefore in carrying out an audit in the UK, auditors are required to follow both. Additional words would only serve to add to the boiler plating which the APB is trying to avoid.

**7. Should auditors be required to state in their report, where it is appropriate, that there are no matters that they wish to emphasise?**

We understand that the view of the Audit Quality Forum outlined in its publication Auditor Reporting suggested that a positive statement in this respect could be added to the audit report, however, this was caveated with the view that there first needs to be clarity about the definition of what this might include and more importantly what it might exclude.

Until such clarity is provided our view is that there is more value in the rarity of such reporting, if such statements were added as a matter of course, then it would serve to add to the boilerplate language. If there is a matter that needs to be emphasised then the company should emphasise it within the accounts. The auditors' role is to then report on it. If the company has not disclosed something that auditors consider needs reporting, then the auditor will report that fact anyway.

**8(a) Do you think that there should be a positive statement in the auditor's report concerning the adequacy of accounting records?**

This was a matter that was greatly debated by the *Audit Quality Forum*. Firstly, our view is that there needs to be clarity around the definition of "adequate accounting records" and in whose judgement they are "adequate". The APB will be aware that the ICAEW had issued guidance in this area in the past (FRAG 5/92). We note that the FRC is considering developing guidance for directors around their responsibilities in relation to the adequacy of accounting records. Our view is that this guidance needs to be developed as a matter of priority given that the relevant clauses in the Companies Act 2006 are coming into effect from 6 April 2008. In developing this guidance, the FRC should consider the definition and obtain legal advice in relation to what would constitute "adequate". Our view is that the FRC should also develop guidance in this area for auditors.

Additionally, we do not consider that there needs to be a positive statement. Auditors will include a statement within the audit report if they consider that the accounting records are inadequate.

**(b) If not will the steps proposed by the APB to:**

**(i) require auditors to make a statement that they have nothing to report in connection with their duty to consider the adequacy of the accounting records; and**

**(ii) provide additional standards and guidance for auditors with respect to their responsibility with respect to adequate accounting records, address the problem that the AQF is seeking to resolve?**

Once the FRC has provided a clear definition of the term and there is clear guidance for directors around their responsibilities, then the APB can consider this further, including the need to provide standards and guidance for auditors in relation to their responsibility in this area.

**9(a). Should the auditor's report describe the auditor's responsibility with respect to a listed company's Corporate Governance Statement?**

We believe that there is no reason to treat these responsibilities any differently from those as considered as part of Question 5, above. We do not believe that such a statement should be included within the audit report

**9(b) If you believe that the responsibility should be described in a different way to Example 2 please provide your suggested description?**

N/A

**9(c) Please indicate, stating your reasons whether you believe that the standard wording "We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures" (which has been omitted from Example 2) should be included in the auditor's report?**

No, we do not think that this should wording should be included within the audit report. The auditors' responsibilities with respect to the corporate governance statement are clear in Example 2.

**10. Should the auditor's report describe the auditor's responsibilities in relation to "Other Information" in the Annual Report?**

We believe that there is no reason to treat these responsibilities any differently from those as considered as part of Question 5, above.

**11(a). Which of the example auditor's report do you prefer? Please provide the reasons for your choice?**

In the short term, considering the real possibility of future changes to be made by the EU, the most sensible solution is to amend the current audit report just for the minimum changes are required by the Companies Act 2006.

In the medium term we believe it is very important for the APB to influence the standards and guidance concerning audit report such that the report retains flexibility to cater for the differing needs of users for both SMEs and larger, more complex organisations. In this respect we can envisage situations where examples 1 and 2 may individually be appropriate

**11(b) If you would prefer a different approach to these examples please provide your suggested unmodified auditor's report? (Alternatively, tick the boxes in the right hand column of the table on pages 28 to 29 to indicate those elements of an auditor's report that you would like to see included in an unmodified auditor's report.)**

We do, however, consider that there is some merit in the 2 part report provided for by ISA700 revised.

**Including company specific information within the auditor's report**

**12. Do you agree with the view of the IAASB expressed in the Exposure Draft of ISA 706 (Revised and Redrafted) that the widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters?**

In our view, the widespread use of such disclosures may become routine and will diminish the value of the auditors' views of these matters. Their importance as a means of communicating fundamental matters will be lost.



Email: [sumita.shah@icaew.com](mailto:sumita.shah@icaew.com)

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