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# *Discussion Paper*

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



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**December 2007**

**THE AUDITING PRACTICES BOARD**

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## Discussion Paper

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

<b>Contents</b>	<b>Page</b>
<b>1. Introduction</b>	5
<b>2. The development of the UK auditor's report</b>	9
<b>3. Amending the auditor's report to reflect changes in company law</b>	15
<i>Illustrative example of a current auditor's report marked up to reflect the changes arising from the requirements of the Companies Act 2006.</i>	19
<b>4. Other possible improvements to the auditor's report</b>	23
<i>Comparison of the Principal Features of Examples 1-3</i>	35
<i>Example 1</i>	37
<i>Example 2</i>	39
<i>Example 3</i>	41
<b>5. Including company specific information within the auditor's report</b>	43
<b>6. Discussion questions</b>	47
<b>Appendices</b>	
<i>1. Extract from the Companies Act 2006</i>	49
<i>2. Summary of Recommendations of the Audit Quality Forum</i>	53
<i>3. Extract from the Disclosure and Transparency Rules of the United Kingdom Listing Authority and Article 4 of the Transparency Directive</i>	54
<i>4. Example of a French Auditor's Report</i>	56



## 1. INTRODUCTION

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1.1 There is considerable interest, both in the UK and internationally, in the current form and content of the auditor's report. This is demonstrated by:

- Views received by the Financial Reporting Council (FRC) in response to its paper "Promoting Audit Quality".
- The Audit Quality Forum<sup>1</sup> (AQF) paper<sup>2</sup> that considered the information that auditors communicate and how this reflects the purpose of the audit, the expectations of shareholders and the need for further enhancement of the usefulness of auditor's reports.
- The International Auditing and Assurance Standards Board's (IAASB) recent exposure draft of ISA 700 (Redrafted) which proposes clarifications to a standard that itself has not yet been implemented in the UK and Ireland.

1.2 The coming into force of the Companies Act 2006 (CA 2006) will require changes to the wording of UK auditor's reports in 2008. This Discussion Paper (in Chapter 3) sets out how the new requirements might be reflected in the standard auditor's report. An example report, premised on making the minimum necessary changes to the existing auditor's report, is provided in the chapter for illustrative purposes and the APB is consulting on two issues on this.

1.3 Responses to the FRC's "Promoting Audit Quality" revealed a variety of views on the usefulness of the auditor's report. Although the auditing profession was generally comfortable with the current approach, a number of user groups suggested changes to the current format of the auditor's report. These user groups considered current auditor's reports to be overly legalistic and to contain so many caveats and provisos that their usefulness is limited. Some requested a reorganisation of the auditor's report so that the opinion appears earlier in the report whilst others called for more radical changes such as the introduction of narrative reporting to make the auditor's report more informative in areas such as estimates, judgments, sufficiency

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1 The **Audit Quality Forum** is a body that brings together representatives of auditors, investors, business and regulatory bodies. Its purpose is to encourage stakeholders to work together by promoting open and constructive dialogue in order to contribute to the work of government and regulators and by generating practical ideas for further enhancing confidence in the independent audit.

2 The paper can be downloaded from [www.icaew.co.uk](http://www.icaew.co.uk)

of evidence and uncertainties. These views have a strong resonance with the recommendations of the AQF.

1.4 In light of these responses, the APB is taking this opportunity to explore whether other, more wide ranging, changes should be made to the form and content of the auditor's report. Chapters 4 and 5 explore other possible changes and seek views on ten issues related to them. At the end of Chapter 4 examples of three possible auditor's reports are provided for illustrative purposes. These cover a spectrum of possibilities ranging from full application of ISA 700 (Revised) to the minimum content required by CA 2006.

1.5 The extent to which the content of auditor's reports can be determined by the APB alone will depend upon decisions taken at a European level with respect to the Statutory Audit Directive. Under the Statutory Audit Directive the European Commission (EC) is able either to adopt ISA 700 (Redrafted) for use in the European Union (EU), or to develop its own "European Audit Report" which would have to be applied in all European countries, including the UK. It is not known which of these two options the EC is likely to pursue.

1.6 The APB hopes that the responses it receives to this Discussion Paper will be of assistance:

- To the APB in determining how best to change auditor's reports to implement CA 2006.
- To the EC in deciding which approach to take when implementing the Statutory Audit Directive.
- To the IAASB in determining the content of ISA 700.

1.7 Responses to this paper are requested by 28 March 2008. This timing will permit the APB to assimilate the comments received in order to determine:

- (a) the content of the guidance it should issue for auditors reporting in accordance with the Companies Act 2006; and whether it is necessary
- (b) to develop an Exposure Draft of a revision of ISA 700 (UK and Ireland).

1.8 This timing will provide sufficient lead time for auditor's reporting on accounting periods beginning on or after 6 April 2008 (the effective date for the relevant requirements of CA 2006).

1.9 This consultation relates to UK auditor's reports. Irish auditor's reports are not dissimilar to UK auditor's reports but differ because of different underlying legal requirements. The extent of the differences will be exacerbated by CA 2006 being implemented in the UK. If the APB decides to make significant changes to the UK auditor's report as a result of this consultation it will consult, as a separate exercise, on whether the changes should also be applied to Irish auditor's reports.



The APB welcomes the views of all parties interested in auditing and auditor's reports on the matters discussed in this paper.

Commentators are being asked to address questions at two levels:

(1) Chapter 3 and questions 1 and 2 address changes that will need to be made to the standard auditor's report to reflect changes in company law arising from the coming into force of CA 2006.

(2) Chapters 4 and 5 and questions 3 to 12 address more wide ranging changes to the auditor's report. Where commentators advocate more wide ranging changes to the auditor's report it would be helpful if they would indicate whether they consider that such changes should be made concurrently with the changes necessary to implement CA 2006 or should await a decision by the EC as to whether or not to endorse ISA 700 for use in Europe.

Although the Discussion Paper raises specific questions, commentators should not feel that they are constrained by those questions, or required to answer all of them. However, it will assist the collation of views if the questions are used to structure responses on this topic.

Comments, to reach the APB by 28 March 2008, should be addressed to:

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All responses will be regarded as being on the public record unless confidentiality is expressly requested.



## 2. THE DEVELOPMENT OF THE UK AUDITOR'S REPORT

### *The first UK standard on audit reporting*

2.1 The UK's first Auditing Standard on the subject of audit reporting was issued in 1980. The Auditing Practices Committee (APC<sup>3</sup>) announced the publication of the Discussion Draft of the proposed Standard as follows:

*"When we come to the wording of auditors' reports, Auditing Standards are like accounting standards in that they are designed to reduce the differences that currently exist in reporting on accounts, not for the sake of blind uniformity, but so that those who read accounts may more readily grasp the message that the auditor wants to convey.*

*Codification of good auditing practice into a set of Standards will also help to satisfy our critics in political circles and outside who accuse us of not setting down clearly what an auditor is supposed to do. By adopting these Standards, we shall be going some way to proving that self-regulation does work. ... One day we shall wonder how we ever managed without them"*<sup>4</sup>.

2.2 The 1980 Standard proposed the following standard unqualified auditor's report. Although the essence of the opinion remains the same today, the report is very succinct when compared to audit reports that are currently being issued.

3 The APC was formed in March 1976 by the Consultative Committee of Accountancy Bodies to develop auditing standards. It was formed in response to "recent public questions on the quality of auditing". Prior to the issuance of auditing standards guidance for their members was published by the various Institutes of Accountants.

4 True & Fair, Bulletin of the Auditing Practices Committee Issue No 7 Spring 1978.

## **“AUDITORS’ REPORT TO THE MEMBERS OF .....**

We have audited the financial statements on pages ... to ... in accordance with approved Auditing Standards.

In our opinion the financial statements, [which have been prepared under the historical cost convention as modified by the revaluation of land and buildings], give a true and fair view of the state of the company’s affairs at 31<sup>st</sup> December 19... and of its profit and source of application of funds for the year then ended and comply with the Companies Act 1948 and 1967”.

### *Expanding the auditor’s report in the 1990’s to address the expectations gap*

2.3 A number of prominent audit failures in the 1980s, coupled with concerns about a growing so called “expectations gap”, led to the formation of the Auditing Practices Board (APB) as successor to the APC. Whereas the APC was made up almost entirely of auditors, the membership of the APB comprised auditing practitioners and non-practitioners in equal proportions. Soon after its formation, in 1991, the APB issued, “Proposals for an expanded auditors’ report,” which was intended to address that aspect of the expectations gap that arose because users of auditor’s reports did not understand the scope and nature of an audit.

2.4 Three of the major points of difference between the proposed Statement of Auditing Standards (SAS) and the Auditing Standard issued in 1980 were summarised in the Exposure Draft of the SAS as:

- Auditor’s reports prepared in accordance with the SAS would contain brief descriptions of the respective responsibilities of directors and auditors.
- Auditor’s reports would set out the basis for the opinion expressed and include a description of the key features of the audit process.
- Auditors would draw attention to the way in which certain fundamental uncertainties have been treated in the financial statements (i.e. emphases of matter).

In view of the support of respondents to these proposals the APB concluded that these changes in reporting practice would allow, and encourage, auditors to report in a more informative manner.

2.5 This Exposure Draft became SAS 600 which was effective for financial periods ending on or after 30 September 1993. In light of the discussion that follows of the AQF recommendation that more company specific information be included within the auditor’s report, (see Chapter 5), it is interesting to note that guidance in SAS 600 encouraged auditors to include additional comment in the basis of opinion section of their report “to highlight matters which they regard as relevant to a proper understanding of the basis of their opinion”.

### *Expanding the auditor’s report in 1998 to deal with reporting on corporate governance*

2.6 During the 1990’s the Combined Code was issued and subsequently the Listing Rules of the London Stock Exchange required auditors to review a listed company’s

compliance with certain aspects of the Code. The Listing Rules did not, however, require the auditor to report the results of their review.

2.7 The APB sought to address the ambiguities or misunderstandings that could arise if auditors were known to have reviewed information, but readers of that information were unaware of the scope of the review, its inherent limitations and its conclusions. A form of report (separate from the auditor's report on the financial statements) was, therefore, developed which auditors could use to communicate their findings arising from their review. In various Bulletins the APB recommended that auditors should encourage the directors to publish such reports in the annual report. (Neither the APB nor auditors were in a position to mandate the publication of such reports).

2.8 In 1998 the APB published a paper<sup>5</sup> in which it discussed the adequacy of communication in those annual reports where, either there was no mention of the auditor's involvement with the directors' corporate governance disclosures, or the directors spoke on behalf of the auditors.

2.9 Following this consultation the APB issued a further Bulletin, Bulletin 1998/10<sup>6</sup>, in which it encouraged the inclusion of a clear statement of auditor's responsibilities, including their responsibilities with respect to corporate governance matters, in the annual reports of listed companies. The Bulletin recommended that the auditors' responsibilities either be included as a separate section of the auditor's report on the financial statements or set out as a separate statement within the annual report.

2.10 In its 1998 Paper, the APB expressed a preference for a statement separate from the auditor's report because, *"The APB does not believe that it is desirable for these responsibilities to be dealt with through increasingly complex drafting of the introductory paragraph of the audit report on the financial statements. Such drafting detracts from the essential messages that the audit report on the financial statements is intended to convey"*.

2.11 However, since Bulletin 1998/10 was issued, practice has developed whereby the auditor's responsibilities are almost invariably described in the auditor's report rather than in a separate auditor's responsibility statement within the annual report. This practice has arisen because many companies and auditors prefer the annual report to include only one report from the auditor. Auditors may have preferred having a single auditor's report because there was perceived to be a risk in circumstances where a modified auditor's report on the financial statements was not read by a user and, having read the unmodified report on corporate governance matters, the user presumed that this was the totality of what the auditor was reporting.

#### *Other wording included in auditor's reports to address liability concerns*

2.12 Following the judgment in *Royal Bank of Scotland v Bannerman Johnstone Maclay and others* (Bannerman) in 2003, the Audit and Assurance Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) advised its members to include the following words in auditor's reports.

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5 "Auditor's responsibility statements and auditors' reports on corporate governance" APB June 1998

6 Bulletin 1998/10, "Corporate Governance Reporting and Auditors' Responsibilities Statements"

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

2.13 The ICAEW believed that this wording was necessary because the Bannerman judgment highlighted the potential exposure of auditors to parties, other than the members of a company as a body, who assert that they rely on audit reports, in circumstances where the auditor has failed expressly to disclaim responsibility to those third parties.

2.14 The APB does not include this wording in the illustrative auditor's reports that it publishes because its policy is not to address those matters that have, or might have, the effect of limiting auditors' liability to third parties. This wording is a significant feature of auditor's reports that are being issued at present. It may be timely to reconsider the need for the "Bannerman" statement.

### *Introduction of ISA (UK and Ireland) 700*

2.15 SAS 600 was withdrawn when the APB issued a suite of International Auditing Standards (ISAs) (UK and Ireland) that were applicable to the audits of financial statements for periods commencing on or after 15 December 2004. SAS 600 was replaced by ISA (UK and Ireland) 700 and example illustrative auditor's reports were initially provided in Bulletin 2005/4 and subsequently in Bulletin 2006/6. As SAS 600 had always been closely aligned to ISA 700 this change did not have a significant impact on the wording of auditor's reports. Changes that did occur to the auditor's report at this time arose from the need to reflect a number of changes in the requirements of company law.

### *The APB's approach to IAASB's revision to ISA 700*

2.16 In December 2004 the IAASB finalised and issued ISA 700 (Revised). During 2005 the APB exposed for public comment a proposed revision of ISA (UK and Ireland) 700 that adopted the text of ISA 700 (Revised). The APB Exposure Draft proposed the same implementation timetable as for ISA 700(Revised).

2.17 A number of concerns were raised by commentators. These concerns included:

- **"True and Fair"**. Institutional investors were unhappy at the indication that "true and fair" and "presents fairly, in all material respects" were equivalent terms. There was also dissatisfaction with the suggestion in the proposed revised ISA that there are or should only be "extremely rare" circumstances where departure from a specific requirement in the financial reporting framework would be required to avoid misleading financial statements and ensure that the financial statements give a true and fair view. It was suggested that this statement reflected an undue focus on formulaic compliance with accounting standards.

- **“Objective of an audit”**. Institutional investors wanted auditors’ reports to have more focus on the law requiring auditors to “form an opinion on the financial statements” — rather than to perform an audit in accordance with auditing standards.
- **“Concern regarding the description of management’s responsibilities”**. The Confederation of British Industry (CBI) questioned whether the wording of the management responsibilities accurately reflected the legal responsibilities of directors and expressed concern that the descriptions could encourage unwarranted claims from or disputes with third parties.
- **“Focus on process”**. Institutional investors were concerned that the proposed auditor’s report was too focussed on process and was so long that the opinion was lost in standardised text.

2.18 After considering responses to the exposure draft, the APB concluded that any revision of ISA (UK and Ireland) 700 should be deferred until progress had been made on:

- **Changes to the UK Companies Act**. As discussed in Chapter 3, CA 2006 has now been enacted.
- **Clarification as to what form of audit opinion would apply throughout the EU**. The Statutory Audit Directive, which revised the 8<sup>th</sup> Directive, came into force in June 2006. The Directive provides for the adoption of ISAs within the EU but the process by which that is to be achieved had still to be established. One of the primary reasons for the revision of ISA 700 by the IAASB was to introduce an auditor’s report that could be applied consistently in different jurisdictions, including throughout the EU. However, it was not known whether the form and wording of the auditors report required by the revised ISA 700 would be approved for adoption in the EU. This uncertainty still remains.
- **Updates to the ISAs dealing with modified auditor’s reports**. These standards (ISAs 705 and 706) have now been finalised by the IAASB, subject to further redrafting as part of its Clarity Project.

2.19 In discussing the deferral of the adoption of ISA 700 (Revised), the Chairman of the APB commented:

*“The APB is supportive of the global harmonisation of auditing standards that enhance the quality of auditing and of the work of the IAASB. However, we have concluded that the time is not right for the APB to adopt the latest version of ISA 700, with the possibility that further changes in the form and content of the auditor’s report may be necessary within a relatively short period of time”.*





### 3. AMENDING THE AUDITOR'S REPORT TO REFLECT CHANGES IN COMPANY LAW

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3.1 A number of the provisions of CA 2006 are intended to specify the wording used in the opinion paragraphs of UK auditor's reports. Certain other provisions whilst not expressly intended to specify the wording used in auditor's reports may, by implication, justify further changes to the wording of the auditor's report.

3.2 The sections of CA 2006 that are expressly intended to specify the wording of the opinion paragraph are:

- Section 495 "Auditor's report on company's annual accounts"
- Section 496 "Auditor's report on directors' report"
- Section 497 "Auditor's report on auditable part of directors' remuneration report"
- Section 498 "Duties of Auditor"

3.3 The sections of CA 2006 that might justify further changes to the content of the auditor's report are:

- Section 393 "Accounts to give true and fair view"
- Section 493 "Disclosure of terms of audit appointment"

3.4 Section 493 enables the Secretary of State to make regulations for securing the disclosure of the terms on which a company's auditor is appointed, remunerated or performs its duties. As the Secretary of State has not yet exercised these powers the potential effect of this provision of the Companies Act is considered in Chapter 4 rather than in this chapter.

3.5 These sections of CA 2006 will be effective for accounting periods commencing on or after 6 April 2008. For convenience the text of these sections is reproduced in Appendix 1.

## REQUIREMENTS CONCERNING THE AUDITOR'S REPORT

### *Audit opinion required by section 495 (3) of CA 2006*

3.6 The main substantive change from the equivalent requirements of the Companies Act 1985 (CA 1985) is that Section 495(3) of CA 2006 requires the auditor to give an opinion as to whether the annual accounts:

- (a) give a true and fair view of the state of affairs and profit or loss for the year;
- (b) have been properly prepared in accordance with the relevant financial reporting framework; and
- (c) have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).

(The so called three-part-opinion)

3.7 In contrast to (a) and (b) in the three-part-opinion, CA 1985 (as amended by the Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004) requires the auditor to give an opinion as to whether the annual accounts give a true and fair view, in accordance with the relevant financial reporting framework, of the state of affairs and profit or loss for the year. The change was made as some considered that the underlined wording constrained the scope of a “true and fair” opinion. The removal of these words from the equivalent requirement in CA 2006 is intended to clarify the position.

3.8 The example auditor's report on pages 19 to 21 illustrates, by mark up, how a current auditor's report might be amended to reflect the changes arising from the requirements of CA 2006.

### *Early adoption of the audit opinion required by section 495 (3) of CA 2006*

3.9 The AQF recommends that the three-part opinion required by CA 2006 be adopted as soon as possible rather than wait for the Act to come into force.

3.10 The APB does not propose to take this recommendation forward because:

- It would be inappropriate to implement section 495 (3) of CA 2006 in isolation. As discussed in paragraphs 3.11 to 3.13, section 393 will require directors of a company not to approve accounts (including IAS<sup>7</sup> Accounts) unless they are satisfied that they give a true and fair view and for the auditor to have regard to the director's duty in carrying out its function under CA 2006. It would be unreasonable to implement the audit requirements without implementing the equivalent requirement applicable to directors in section 393.
- Parliament has determined the effective date of CA 2006 and the APB does not have the authority to override Parliament.
- In any event, the wording of auditor's reports will need to meet the requirements of CA 2006 for year ends commencing on or after 6 April 2008. This is not very far into the future. This consultation may lead to the APB deciding to recommend other changes to the auditor's report and the APB's

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7 IAS Accounts. IAS refers to the international accounting standards, within the meaning of the IAS Regulation, that have been adopted from time to time by the EC in accordance with that Regulation. Such international accounting standards are often described as “International Financial Reporting Standards” (IFRSs) as adopted by the European Union.

preference is to make all of the changes together rather than on a piecemeal basis.

- Combining a number of changes to the auditor's report is also likely to be the most practical way forward. The APB is mindful of the fact that changing the auditor's report will add to the costs of auditing firms who will need to communicate the changes to their staff and provide appropriate training. There are also potential costs to users of auditor's reports in understanding the changes made and the reasons for them.

### *Directors required to be satisfied that financial statements give a true and fair view*

3.11 Section 393(1) of CA 2006 requires that the directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the state of affairs and profit or loss for the year. There is no equivalent provision in CA 1985 applicable to companies preparing IAS accounts. This is because for such companies International Accounting Standard (IAS) 1, "*Presentation of Financial Statements*" requires financial statements to "present fairly" the financial position, financial performance and cash flows of an entity. CA 1985 at Section 262 (2A) notes that references in the Act to "true and fair view" are references in the case of IAS accounts to the requirement under international accounting standards that such accounts achieve a fair presentation.

3.12 Section 393(2) requires the auditor of a company in carrying out its functions under CA 2006 in relation to the company's financial statements "to have regard to the directors' duty under subsection (1)".

3.13 The APB is of the view that it would be helpful for the auditor's report to make reference to the directors' responsibility under section 393. When reporting on IAS accounts, in particular, such a reference will make clear that the auditor's and directors' responsibilities, with respect to the true and fair view, are fully aligned with each other.

#### **Question 1**

Should the auditor's report, as illustrated on pages 19 to 21, 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?

### *Reporting by exception*

3.14 Section 498 of CA 2006 requires the auditor in preparing its report to carry out various investigations and to report when:

- (a) adequate accounting records have not been kept by the company;
- (b) the company's individual accounts are not in agreement with the accounting records and returns;
- (c) the auditable part of the Directors' Remuneration Report is not in agreement with the accounting records and returns; and
- (d) the auditor has not received all the information and explanations which, to the best of its knowledge and belief, are necessary for the purposes of the audit.

3.15 Section 498, therefore, requires the auditor to report by exception. If the results of the auditor's investigations reveal no exceptions, CA 2006 does not require the auditor to comment on these matters<sup>8</sup>. These requirements of Section 498 are essentially the same as the requirements of Section 237 of CA 1985.

3.16 Following the publication of APB Bulletin 1998/10 the illustrative auditor's reports issued by the APB refer to the auditor's responsibility in the responsibilities section of the report as follows:

In addition we report to you if, in our opinion, the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

3.17 These words are included in the responsibilities section of the auditor's report so that readers of the auditor's report are aware that the auditor has these responsibilities and can deduce, in the absence of any further comment, that the auditor has nothing to report in respect of these responsibilities. The illustration on pages 19 to 21 illustrates the changes required to be made to this paragraph to reflect CA 2006.

3.18 The APB continues to believe that it is helpful for the auditor's report to describe the auditor's responsibilities to report on certain matters by exception. This is because:

- (a) setting out the auditor's responsibilities in this way may prevent the development of an expectation gap on the part of readers of auditor's reports; and
- (b) inclusion of these words in the auditor's report remind auditors each time that they sign an audit report of the totality of their responsibilities under CA 2006.

3.19 The APB also believes that, where the auditor has nothing to report in connection with these duties, it would be helpful to readers of auditor's reports if the auditor's opinion were to include a statement to that effect. As this would not be a change arising from the implementation of CA 2006 it is not reflected in the example auditor's report on pages 19 to 21. However, this proposal is illustrated in Examples 1 and 2 on pages 37 to 40.

## Question 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?
- (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?

<sup>8</sup> Section 498 of the Act also requires the auditor, so far as it is reasonably able to do so, to include certain particulars in the auditor's report to the extent that they have not been provided by the directors.

# ILLUSTRATIVE EXAMPLE OF A CURRENT AUDITOR'S REPORT MARKED UP TO REFLECT THE CHANGES ARISING FROM THE REQUIREMENTS OF THE COMPANIES ACT 2006

- *This example is based on Example 8 in APB Bulletin 2006/6*
- *Group and parent company financial statements not presented separately.*
- *IFRSs as adopted by the European Union used for group financial statements.*
- *UK GAAP used for parent company financial statements.*
- *Company does meet the Companies Act definition of a quoted company.*
- *Section ~~408~~ **239** exemption taken for parent company's own profit and loss account.*

## INDEPENDENT AUDITOR'S REPORT TO THE [MEMBERS] [SHAREHOLDERS] OF XYZ PLC

We have audited the group and parent company financial statements (the "financial statements") of (name of entity) for the year ended ... which comprise [specify the financial statements, such as the Group Income Statement, the Group and Parent Company Balance Sheets, the Group Cash Flow Statement, the Group Statement of Changes in Equity/Statement of Recognised Income and Expense, that have been audited] and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

### Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union, and for preparing the parent company financial statements and the Directors' Remuneration Report in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) **and for being satisfied that the group and parent company financial statements give a true and fair view**<sup>9</sup> are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view **and have been properly prepared in accordance with the relevant financial reporting framework** and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been **properly** prepared in accordance with the Companies Act **2006** ~~1985~~ and whether, in addition, the group financial statements have been **properly** prepared in accordance with Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Directors' Report is consistent with the financial statements. [The information given in the Directors' Report includes that specific information presented in the Operating and Financial Review that is cross referred from the Business Review section of the Directors' Report.]

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9 S 393(1) CA 2006

In addition we report to you if, in our opinion, the company has not kept **proper adequate**<sup>10</sup> accounting records **or**, if we have not received all the information and explanations we require for our audit or if ~~information specified by law regarding directors' remuneration and other transactions is not disclosed~~ disclosures of directors' benefits, remuneration, pensions and compensation for loss of office specified by law are not made.

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the **2003 2006** Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. 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.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only [the Directors' Report, the unaudited part of the Directors' Remuneration Report, the Chairman's Statement, the Operating and Financial Review and the Corporate Governance Statement]. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

### **Basis of audit opinion**

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

### **Opinion**

In our opinion:

- the group financial statements give a true and fair view, ~~in accordance with IFRSs as adopted by the European Union~~, of the state of the group's affairs as at . . . . . and of its profit[loss] for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the group financial statements have been **properly** prepared in accordance with the Companies Act **2006 1985** and Article 4 of the IAS Regulation;

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<sup>10</sup> Section 498(1)(a) CA 2006



- the parent company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the parent company's affairs as at .....;
- the parent company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice;
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited have been **properly** prepared in accordance with the Companies Act **2006** ~~1985~~; and
- the information given in the Directors' Report is consistent with the financial statements.

**[Separate opinion in relation to IFRSs]**

As explained in Note x to the group financial statements, the group in addition to complying with its legal obligation to comply with IFRSs as adopted by the European Union, has also complied with the IFRSs as issued by the International Accounting Standards Board.

In our opinion the group financial statements give a true and fair view, in accordance with IFRSs, of the state of the group's affairs as at . . . and of its profit [loss] for the year then ended.]

*Registered auditors*  
**Senior statutory auditor**

*Address*  
*Date*





## 4. OTHER POSSIBLE IMPROVEMENTS TO THE AUDITOR'S REPORT

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4.1 In this Chapter changes to the auditor's report going beyond the changes arising solely from the introduction of CA 2006 are considered. A number of these proposals for change were made by the AQF. In Appendix 2 we indicate where in this paper the various proposals of the AQF are addressed.

4.2 In overview the themes of these further possible changes are:

- Issues relating to the possible adoption of ISA 700 (Revised):
  - Whether to adopt the two-part report and if so the manner in which this is done (paragraphs 4.8 and 4.9).
  - Whether the description of management's responsibilities required by ISA 700 is necessary where a description is available elsewhere, for example listed companies subject to the requirements of the Transparency Directive are required to include responsibilities statements in their annual reports (paragraphs 4.10 to 4.14).
  - Whether the description of the auditor's responsibilities is necessary where they are more fully described in a form that is accessible by shareholders (paragraphs 4.15 to 4.19).
  - Whether to require a statement of compliance with the APB ethical standards (paragraphs 4.20 and 4.21).
  - Risk attached to not following the requirements of ISA 700 (Revised) (paragraphs 4.22 to 4.24).
- Including in the auditor's report a positive statement that there are no matters which the auditor wishes to emphasise (paragraphs 4.25 to 4.29).
- Including in the auditor's report a positive statement concerning the adequacy of accounting records. (See discussion in paragraph 3.19 and paragraphs 4.30 to 4.33).
- Discontinuing the description of the auditor's responsibilities under the Listing Rules with respect to Corporate Governance matters (paragraphs 4.34 to 4.39).

- Discontinuing the description of the auditor's responsibilities in relation to the content of the annual report that is not audited (paragraphs 4.40 to 4.43).

At the end of this Chapter three possible illustrative examples for the wording of auditor's reports are set out.

## ISSUES RELATING TO THE POSSIBLE ADOPTION OF ISA 700 (REVISED))

### Background

4.3 In December 2004 the IAASB issued ISA 700 (Revised), "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements". The primary objective of this revision of ISA 700 was to promote credibility in the global market place by making more readily identifiable those audits that had been conducted in accordance with globally recognized standards. When publishing the revised ISA the IAASB asserted *"it is useful to have consistent content, layout and wording in the auditor's reports of audits conducted in accordance with ISAs so that the reports are readily identifiable"*.

4.4 The EC had encouraged IAASB to revise ISA 700 so that it would provide a basis for consistent auditor's reports within the EU. One of the difficulties in achieving this is that while there is a basic requirement to provide a true and fair view opinion in all Member States, many other aspects of the auditor's reports and duties differ between States.

4.5 To address the complexity of different requirements in the various countries of the EU, new guidance in the proposed ISA 700 (Revised) clarified that such responsibilities need to be clearly identified and distinguished, preferably in a separate section of the auditor's report. In this way purely national requirements could be removed from the section of the auditor's report that addresses the financial statements. As a result auditor's reports under ISA 700 (Revised) would be split into two parts.

4.6 In revising ISA 700, the IAASB took account of the wording of auditor's reports in other jurisdictions as well as the audit risk ISAs<sup>11</sup> that the IAASB had recently issued with a view to expanding and updating the wording of the auditor's report to enhance understanding of the auditor's role and the auditor's report. As a result, the proposed new wording for the auditor's report included:

- Revised descriptions of the respective responsibilities of management and the auditor.
- An updated description of the audit process to reflect the Audit Risk Standards.
- Clarification of the scope of the auditor's responsibilities with respect to internal control.

4.7 During 2005 the APB exposed for public comment a proposed revision of ISA (UK and Ireland) 700 that adopted the text of ISA 700 (Revised). However, after considering responses to the exposure draft the APB concluded that the revision of ISA (UK and Ireland) 700 should be deferred. The reasons for the deferral are discussed in more detail in paragraphs 2.16 to 2.19.

<sup>11</sup> The audit risk ISAs are ISA 315 "Understanding the entity and its environment and assessing the risks of material misstatement" and ISA 330 "The auditor's procedures in response to assessed risks".

## *Two-part report*

4.8 The most significant change to the UK auditor's report arising from the adoption of ISA 700 (Revised) would be splitting the auditor's report into two parts:

- (a) the report on the financial statements; and
- (b) the report on other legal and regulatory requirements.

4.9 The APB is generally supportive of the IAASB's objective in splitting the auditor's report into two parts and believes that this is practicable in the UK context. Examples 1 and 2 on pages 37 to 40 illustrate how the two part report, as envisaged by ISA 700 (Revised), might be applied in the UK when CA 2006 is in force.

### **Question 3**

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

## *The description of management's responsibilities*

4.10 In compliance with Article 4 of the Transparency Directive the Disclosure and Transparency Rules of the FSA require issuers whose transferable securities are admitted to trading and whose home state is the United Kingdom to include responsibility statements in the annual report. The Disclosure and Transparency Rules require statements to be included in the annual report that:

- (a) the financial statements have been prepared in accordance with the applicable set of accounting standards and give a true and fair view; and
- (b) the management report includes a fair review of the development and performance of the business . . . together with a description of the principal risks and uncertainties that they face.

For convenience these rules are reproduced in Appendix 3.

4.11 In current UK auditor's reports there is typically a paragraph stating that the directors are responsible for preparing the annual report and the financial statements in accordance with the law and the applicable accounting standards. The paragraph also cross refers the reader to the Statement of Director's Responsibilities included in the annual report. Paragraph 9-1 of ISA (UK and Ireland) 700 requires the auditor's report to include a description of the directors' responsibilities only where the financial statements or accompanying information do not include an adequate description of the directors' responsibilities. The present requirements are aligned with the requirements of Article 4 of the Transparency Directive.

4.12 However, ISA 700 (Revised) would not have the flexibility of paragraph 9-1 of ISA (UK and Ireland) 700 as the auditor would be required to state in the auditor's report:

**that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes:**

- (a) Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and**
- (b) Selecting and applying appropriate accounting policies; and**
- (c) Making accounting estimates that are reasonable in the circumstances.**

Although ISA 700 (Revised) contemplates circumstances when it is appropriate for the auditor to add to this description of management's responsibilities to reflect additional responsibilities, it does not contemplate any variation from the wording in the above box.

4.13 One of the reasons for the APB deciding not to adopt ISA 700 (Revised) was because it did not support the approach of ISA 700 (Revised) in prescribing the wording of the directors' responsibilities in the manner required. The APB would prefer that the auditor's report:

- state that the directors are responsible for the financial statements;
- describe the financial reporting framework that the directors have adopted; and
- state the directors' duty to ensure that they give a true and fair view.

The Disclosure and Transparency Rules provide for adequate disclosure of the directors' responsibilities in the Annual Report of listed companies. Where there is adequate disclosure of the directors' responsibilities in the annual report, and subject to any decision of the EC regarding the adoption of ISA 700 (Revised), the APB would like to have the flexibility to depart from the wording stipulated by the ISA.

4.14 The approach adopted in Examples 1 and 2 would go some way to satisfying the recommendation of the AQF report to take steps to improve the readability of the auditor's report. The AQF report suggested that the standardised generic information should not obscure the expression of the auditor's opinion and suggested among other things that standardised generic information be placed in an appendix. In Example 2 the amount of standardised information relating to the directors' responsibilities is less than that required by ISA 700 (Revised) (see paragraph 4.12) and less than current practice in the UK (see illustration on pages 19 to 21).

#### **Question 4**

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

## *The description of the auditor's responsibilities*

4.15 Section 495(2) of CA 2006 requires the auditor's report to include "a description of the scope of the audit identifying the auditing standards in accordance with which the audit was conducted".

4.16 Section 493 of CA 2006 enables the Secretary of State to make provision by regulations for securing the disclosure of the terms on which a company's auditor is appointed, remunerated or performs his duties. At the time of writing the Secretary of State has neither made, nor proposed, any such regulations.

4.17 As can be seen from the illustrative auditor's report on pages 19 to 21, the description of the auditor's responsibilities in current auditor's reports is relatively lengthy, being expressed in some five paragraphs of text. One way of streamlining the description of the auditor's responsibilities is illustrated in Example 2 which uses the following wording with respect to the part of the auditor's report that addresses the financial statements:

Our responsibility is to audit the financial statements in accordance with the requirements of the Companies Act 2006 and International Standards on Auditing (UK and Ireland) and to express an opinion on the financial statements. In forming our opinion we are also required to comply with APB's Ethical Standards.

4.18 This wording has been drafted on the presumption that information explaining the auditors responsibilities is available in a form that can be readily accessed by shareholders and others, for example by published engagement letters or by disclosures such as "Transparency Reports" on the auditor's web-site. Although not suggested by the AQF, the Bannerman wording described in paragraphs 2.12 to 2.14 could similarly be relocated from the auditor's report into a publicly available description of responsibilities.

4.19 ISA 700 (Revised), however, is prescriptive with respect to the wording that should be used to describe the work an auditor performs in an audit and requires the following words to be used in the auditor's report:

**An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.**

Example 1 illustrates a report that meets this requirement of ISA 700 (Revised).

### Question 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?

#### *APB Ethical Standards*

4.20 The illustrative audit reports included within ISA 700 (Revised) include a reference to the fact that performing an audit in compliance with the ISAs requires the auditor to "comply with ethical requirements". However, there is no requirement to specify which ethical requirements the auditor is complying with. Illustrative audit reports presently issued by the APB do not refer to the need for auditor's to comply with APB's Ethical Standards.

4.21 The APB is of the view that referring to compliance with the APB's Ethical Standards in auditor's reports would provide useful information to users and reinforce the need for compliance with them.

### Question 6

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

#### *Risk attached to not following the requirements of ISA 700 (Revised)*

4.22 If, following consultation, Example 2 were to be the preferred option, the APB would be concerned that it would not comply with the requirements of ISA 700 (Revised).

4.23 ISA 700 (Revised) does provide for derogation from its requirements in circumstances where national law obliges an auditor to use a layout or wording in the auditor's report which differs from that required by the ISA. In such circumstances the ISA permits the auditor's report to state that the audit has been conducted in accordance with the ISAs if it includes the elements described in paragraph 65 of ISA 700 (Revised). However the ISA (at paragraph 66) elaborates that the derogation only applies where the specific requirements of a particular jurisdiction conflict with the ISAs. Where there is no conflict the auditor is required to adopt the layout and wording used in ISA 700 (Revised) in order that users can more readily recognise the audit report as a report conducted in accordance with ISAs. As the variations from the requirements of ISA 700 proposed in Example 2 do not arise from conflicts between ISA 700 and CA 2006 the derogation may not apply. Consequently if the UK were to adopt Example 2 it may be precluded from stating that the audit has been conducted in accordance with the ISAs.

4.24 In its comments to the IAASB on its recent Exposure Draft of ISA 700 (Redrafted), which reformats ISA 700 (Revised) in accordance with the IAASB's clarity principles, the APB has made a number of recommendations that would enable Example 2 to be adopted in the UK and still permit an auditor to state that the audit has been conducted in accordance with the ISAs.



## **THE AUDITOR'S REPORT SHOULD CONTAIN A POSITIVE STATEMENT THAT THERE ARE NO MATTERS WHICH THE AUDITOR WISHES TO EMPHASISE**

4.25 The AQF paper recommends that auditor's reports include a positive statement that there are no matters that auditors wish to draw attention to by way of emphasis under Section 495(4)(b) of CA 2006. This recommendation goes beyond the requirements of CA 2006. ISA 706 (Revised and Redrafted) "Emphasis of matter paragraphs and other matter(s) paragraphs in the independent auditor's report" describes the nature of an emphasis of matter paragraph as follows:

In rare circumstances, the auditor may consider a matter presented or disclosed in the financial statements to be of such importance to users' understanding of the financial statements as a whole that it would be appropriate to draw their attention to it. An Emphasis of Matter paragraph in the auditor's report provides the means for the auditor to do so. However, a widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters.

4.26 The AQF paper noted that shareholders would infer from a positive statement that the "absence of any emphasis reference was the result of a positive consideration by the auditors". However, the AQF paper does not provide any empirical evidence to support the view that auditors are not giving appropriate consideration of whether to emphasise particular matters in their report.

4.27 The APB has considered the implications of the AQF recommendation in the context of the IAASB's position that the benefit of emphasis of matter paragraphs to investors and shareholders lies in their rarity rather than their abundance. If the AQF proposal were adopted it may change the attitude of auditors towards disclosing emphases of matter as being the rule rather than the exception. Such a change in attitude may create difficulties for the UK capital markets. At present the Listing Rules require a new applicant for listing to have published or filed audited accounts that cover at least three years and have been reported on by the auditor without modification. The definition of a modified auditor's report in the Listing Rules encompasses reports that contain an emphasis of matter. If the number of emphases of matter were to proliferate as a result of a change in auditor mind-set it may create difficulties for companies that subsequently seek a listing.

4.28 ISA 706 is presently being developed by the IAASB. As part of this process the IAASB has proposed that the following new requirement be added to ISA 706:

When the auditor considers it appropriate to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to the users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements<sup>12</sup>.

12 Paragraph 7, Proposed International Standard on Auditing 706 (Revised and Redrafted), IAASB July 2007

4.29 The benefit of this new requirement is that it provides a rationale for when an auditor's report should include an emphasis of matter paragraph. However, the rationale is very subjective. Users of financial statements may conclude that there are many matters within the financial statements that are "fundamental" to their understanding of the financial statements and could be aggrieved if these were not highlighted in an Emphasis of Matter paragraph. This risk could cause the auditor to become defensive and emphasise a large number of matters.

#### **Question 7**

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

### **POSITIVE STATEMENT CONCERNING THE ADEQUACY OF ACCOUNTING RECORDS**

4.30 The AQF paper recommends that auditor's reports should go further than the current legal requirement and include a positive statement that adequate accounting records have been kept. As discussed in paragraphs 3.18 to 3.19, the APB is proposing that a statement be made by the auditors that they have nothing to report in connection with their duty to report if adequate accounting records have not been kept. In the APB's view this is equivalent to the making of the positive statement recommended by the AQF.

4.31 The APB would be concerned if the AQF is justified in concluding that some auditors may not be paying sufficient attention to their duty to make a statement in the auditor's report when, in their opinion, adequate accounting records have not been kept. Including a positive statement in the auditor's report may encourage auditors to pay more attention to this statutory obligation. However, rather than requiring a positive statement the APB, as discussed in paragraph 3.19 recommends the inclusion in the auditor's report of a statement that the auditor has nothing to report in connection with this duty. The APB also believes that further guidance for auditors regarding this duty may also be beneficial.

4.32 The FRC is considering developing guidance for directors with respect to the provisions of CA 2006 relating to the directors' responsibilities for maintaining adequate accounting records. Once guidance for directors has been developed, the APB will develop standards and/or guidance to reinforce the requirements of CA 2006 with respect to the auditor's duty to form an opinion on the adequacy of the accounting records.

4.33 The APB considers that these steps in aggregate should be sufficient to influence auditor behaviour in this regard.



### Question 8

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

### *ISSUES RELATING TO THE AUDITOR'S RESPONSIBILITIES UNDER THE LISTING RULES<sup>13</sup> WITH RESPECT TO CORPORATE GOVERNANCE MATTERS*

4.34 Listing Rule 9.8.10R (2) requires the auditor to review 9 of the 48 Combined Code provisions. These 9 provisions are those which relate to accountability and audit and that are considered to be objectively verifiable. The Listing Rules are silent as to whether the auditor should report on its review of the directors' compliance statement and whether any such report should be published or referred to in the annual report.

4.35 The APB has taken the view that if the auditor's report contains a description of the auditor's responsibilities under the Listing Rules there is no necessity for a separate auditor's report dealing with the auditor's review of corporate governance matters.

4.36 The wording that the APB includes in its published illustrative auditor's reports, with respect to these responsibilities, is as follows:

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. 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.

4.37 The intention behind including this wording in the auditor's report is to explain the extent of the auditor's limited responsibilities with respect to the Corporate Governance Statement and thereby to prevent an expectation gap developing. The APB had been concerned that users of annual reports may expect all the corporate governance disclosures to have been either audited or reviewed by the auditor.

<sup>13</sup> The Government has announced that it intends to implement the requirement for a corporate governance statement, contained in Directive 2006/46/EC to be implemented via the FSA Rules. The APB understands that the FSA will soon be publishing a Consultation Paper concerning possible changes to its Rules in this regard.

4.38 However, as this wording does not vary between auditor's reports and there is some 10 years experience of working with the Combined Code, much of it may be considered to be unnecessary standard language that could be removed from the auditor's report.

4.39 As illustrated in Example 2, therefore, the APB recommends that much of the first sentence in the box above be retained in the opinion paragraph where the auditor states that it has nothing to report with respect to this responsibility. It is further recommended that the second sentence in the box above be deleted from the APB's standard illustrative auditor's report on the grounds that these limitations to the auditor's responsibility are now well understood and that repeating them in all audit reports does not provide decision useful information to users. Further, if the auditor's engagement letter or an auditor's transparency report were publicly available this standard language would be available to readers of the auditor's report by those means.

#### Question 9

- (a) Should the auditor's report describe the auditor's responsibility with respect to a listed company's Corporate Governance Statement?
- (b) If you believe that the responsibility should be described in a different way to Example 2 please provide your suggested description?
- (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?

### *THE AUDITOR'S RESPONSIBILITY IN RELATION TO THE CONTENT OF THE ANNUAL REPORT THAT IS NOT AUDITED*

4.40 Current UK auditor's reports include a paragraph in the responsibilities section on the auditor's responsibility to read what the ISAs describe as "Other Information" contained in the annual report. This responsibility arises from the following requirement of ISA (UK and Ireland) 720:

**2-1 If, as a result of reading the other information, the auditor becomes aware of any apparent misstatements therein, or identifies any material inconsistencies with the audited financial statements, the auditor should seek to resolve them.**

4.41 The wording that the APB includes in its published illustrative auditor's reports to describe these responsibilities is as follows:

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Directors' Report<sup>14</sup>, the Chairman's Statement, the Operating and Financial Review and the Corporate Governance Statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the group financial statements. Our responsibilities do not extend to any other information.

4.42 The UK and Ireland are the only countries, of which we are aware, where this responsibility is explicitly described in the auditor's report. This development arose from the APB's 1998 consultation discussed in paragraph 2.8.

4.43 The APB has no intention of changing the auditor's responsibilities with respect to reading "other information". However, because the second paragraph of the auditor's report refers to the audit being performed in accordance with ISAs (UK and Ireland), which include ISA (UK and Ireland) 720 it may be unnecessary for the auditor's report to make explicit reference to this responsibility.

#### Question 10

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

### POSSIBLE EXAMPLES OF FUTURE AUDITOR'S REPORTS

4.44 At the end of this Chapter three possible examples for the wording of future auditor's reports are set out. All of the examples meet the requirements of CA 2006 as described in the previous chapter. The examples are differentiated as follows:

- Example 1, which is the longest, is based on present practice and fully meets the requirements of ISA 700 (Revised). In particular the example adopts the two part report as required by ISA 700 (Revised) and as discussed in paragraph 3.19 states that the auditor has nothing to report with respect to its responsibilities under CA 2006 and the Listing Rules where the auditor is required to report by exception.
- Example 2 has its basis in Example 1 but, as discussed above:
  - Omits the description of the audit that is required by paragraph 37 of ISA 700 (Revised).
  - Does not use the wording for management's and the auditor's responsibilities prescribed by ISA 700 (Revised).
  - Omits the description of the limitation of the auditor's review with respect to Corporate Governance matters.

<sup>14</sup> Section 496 of CA 2006 requires the auditor to state its opinion as to whether the information given in the directors' report for the financial year for which the accounts are prepared is consistent with those accounts. At present this statutory responsibility is referred to in an earlier paragraph of the auditor's report. The need for the reference to the directors' report in the paragraph quoted above arises because the requirements of ISA 720 (UK and Ireland) are more extensive than the statutory requirements.

- Example 3 is the shortest possible report that complies with the requirements of CA 2006. This example does not:
  - Adopt the two part audit report required by ISA 700 (Revised).
  - Make any reference to management's responsibilities.
  - Use the wording for the auditor's responsibilities set out in ISA 700 (Revised).
  - Include the description of the audit that is required by paragraph 37 of ISA 700.
  - Describe the duties of the auditor under CA 2006 to report by exception.
  - Describe the duties of the auditor with respect to Corporate Governance matters.
  - Describe the duty of the auditor to read "Other Information" in the Annual Report.

4.45 A comparison of the principal features of each of the examples is depicted in the table on page 35.

#### **Question 11**

- (a) Which of the example auditor's report do you prefer? Please provide the reasons for your choice?
- (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 35 and 36 to indicate those elements of an auditor's report that you would like to see included in an unmodified auditor's report.)

## COMPARISON OF THE PRINCIPAL FEATURES OF EXAMPLES 1 to 3.

Feature	Example 1	Example 2	Example 3	Respondents recommendation
<b>CA 2006 requirements</b>				
An introduction identifying the annual accounts and the financial reporting framework	✓	✓	✓	
A description of the scope of the audit identifying the auditing standards in accordance with which the audit was conducted	✓	✓	✓	
Detailed requirements for the opinion	✓	✓	✓	
Statement that directors' report consistent with accounts	✓	✓	✓	
State that the Directors Remuneration Report has been properly prepared in accordance with CA 2006	✓	✓	✓	
<b>ISA 700 (revised) requirements</b>				
Two-part report as required by ISA 700	✓	✓	x	
An introductory paragraph that identifies the financial statements audited	✓	✓	✓	
A description of management's responsibility for the preparation and fair presentation of the financial statements	✓	x	x	
A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit that includes: A reference to ISAs; and that the auditor plans and performs audit to obtain reasonable assurance whether the financial statements are free from material misstatement	✓	x	x	
A description of the work an auditor performs in an audit	✓	x	x	
Reference to the need for the auditor to comply with relevant ethical requirements	✓	✓	x	
An opinion paragraph including a reference to the applicable financial reporting framework used to prepare the financial statements	✓	✓	✓	

Feature	Example 1	Example 2	Example 3	Respondents recommendation
<b>CA 2006 duties</b>				
Whether adequate accounting records have been kept	✓	✓	x	
Whether company's individual accounts are in agreement with the accounting records and returns	✓	✓	x	
Whether the auditable part of the directors remuneration report is not in agreement with the accounting records	✓	✓	x	
Whether the auditor has obtained all the information and explanations which are necessary for the purposes of the audit.	✓	✓	x	
Statement giving required particulars where certain disclosures specified by law are omitted	✓	x	x	
<b>Listing Rules duties</b>				
Requirement to review nine provisions of the Combined Code	✓	✓	x	
Description of limitation of auditor's review	✓	x	x	
<b>Miscellaneous</b>				
Statement in the second part of the opinion that there is nothing to report with respect to those matters where the auditor is required to report by exception	✓	✓	x	
Including in the auditor's report a positive statement that there are no matters which the auditor wishes to emphasise	x	x	x	
Including in the auditor's report a positive statement concerning the adequacy of accounting records	x	x	x	

## EXAMPLE 1

### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF XYZ PLC

#### Report on the financial statements

We have audited the group and parent company financial statements (the “financial statements”) of (name of entity) for the year ended ... which comprise [specify the financial statements, such as the Group and Parent Income Statements, the Group and Parent Balance Sheets, the Group and Parent Cash Flow Statements, the Group and Parent Statements of Changes in Equity, that have been audited] and the related notes. These financial statements have been prepared under the accounting policies set out therein.

#### Directors' responsibilities

The directors are responsible for the preparation of these financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and for being satisfied that they give a true and fair view. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

#### Auditor's responsibilities

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing (UK and Ireland). Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance [as to] whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements. We believe the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### Opinion

In our opinion the financial statements:

- give a true and fair view of the state of the group's and the parent company's affairs as at ... and of the group's and the parent company's profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and

- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

## Report on other legal and regulatory requirements

### Auditor's responsibilities

In addition to reporting on the financial statements, United Kingdom law and regulations require us to:

- (a) Audit the information in the Directors' Remuneration Report that is described as having been audited<sup>15</sup>.
- (b) State in our report whether, in our opinion, the information given in the Directors' Report is consistent with the financial statements.
- (c) Report to you if, in our opinion:
  - Adequate accounting records have not been kept, or that returns adequate for our audit have not been received from branches not visited by us.
  - The parent company financial statements are not in agreement with the accounting records and returns.
  - The part of the Directors' Remuneration Report to be audited is not in agreement with the accounting records and returns.
  - We have not received all the information and explanations we require for our audit.
- (d) Include in our report a statement giving the required particulars where disclosures of directors' benefits, remuneration, pensions and compensation for loss of office specified by law are not made.
- (e) Review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority and report if it does not. We are not required to consider whether the board's statement on internal control cover all risks and control, or form an opinion on the effectiveness of the company's corporate governance procedures or its risk and control procedures.

### Opinion

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report is consistent with the financial statements.

We have nothing to report to you in respect of our responsibilities set out in (c), (d) and (e) above.

*Registered auditors*  
*Senior statutory auditor*

*Address*  
*Date*

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<sup>15</sup> This is applicable to quoted companies only



## EXAMPLE 2

### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF XYZ PLC

#### Report on the financial statements

We have audited the financial statements of (name of entity) for the year ended . . . which comprise [specify the financial statements, such as the Group and Parent Income Statements, the Group and Parent Balance Sheets, the Group and Parent Cash Flow Statements, the Group and Parent Statements of Changes in Equity, that have been audited] and the related notes.

#### Respective responsibilities of directors and auditors

The directors are responsible for the preparation of these financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with the requirements of the Companies Act 2006 and International Standards on Auditing (UK and Ireland) and to express an opinion on the financial statements. In forming our opinion we are also required to comply with APB's Ethical Standards.

#### Opinion

In our opinion the financial statements:

- give a true and fair view of the state of the group's and the parent company's affairs as at . . . and of the group's and the parent company's profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

#### Report on other legal and regulatory requirements

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report is consistent with the financial statements.

We have nothing to report to you in respect of our responsibilities:

- to report to you if, in our opinion:
  - Adequate accounting records have not been kept, or that returns adequate for our audit have not been received from branches not visited by us.
  - The parent company financial statements are not in agreement with the accounting records and returns.
  - The part of the Directors' Remuneration Report to be audited is not in agreement with the accounting records and returns.

- We have not received all the information and explanations we require for our audit.
- to review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2006 Combined Code specified for our review by the Listing Rules of the Financial Services Authority.

*Registered auditors*  
*Senior statutory auditor*

*Address*  
*Date*

## EXAMPLE 3

### INDEPENDENT AUDITOR'S REPORT TO THE SHAREHOLDERS OF XYZ PLC

We have audited the financial statements of (name of entity) for the year ended . . . which comprise [specify the financial statements, such as the Group and Parent Income Statements, the Group and Parent Balance Sheets, the Group and Parent Cash Flow Statements, the Group and Parent Statements of Changes in Equity, that have been audited] and the related notes. These financial statements have been prepared in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

#### **Auditor's responsibilities**

Our responsibility is to audit the financial statements in accordance with the requirements of the Companies Act 2006 and International Standards on Auditing (UK and Ireland). The Companies Act 2006 also require us to audit the information in the Directors' Remuneration Report that is described as having been audited and to state whether the information given in the Directors' Report is consistent with the financial statements.

#### **Opinion**

In our opinion the financial statements:

- give a true and fair view of the state of affairs as at . . . and of the profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

Further, in our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006<sup>16</sup>; and
- the information given in the Directors' Report is consistent with the financial statements.

*Registered auditors*  
*Senior statutory auditor*

*Address*  
*Date*

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16 This is applicable to quoted companies only.



## 5. INCLUDING COMPANY SPECIFIC INFORMATION WITHIN THE AUDITOR'S REPORT

5.1 The most radical recommendation of the AQF with respect to the auditor's report is that more information should be provided to investors through the medium of the auditor's report. Research undertaken by the AQF indicated that shareholders considered the following would be helpful:

- More information about emphases of matter and references to uncertainty and future risk.
- Discussion of material issues encountered during the audit and their resolution.
- Tailored company reports rather than a standardised report.
- Alternative accounting treatments considered and the reasons for adopting the treatment chosen, where material.
- More information on material areas of judgment and difficult or sensitive issues.

5.2 The AQF report commented that French audit reports provide a possible model of expanded reporting. The report suggested that there is merit in considering whether the sort of expansive reporting illustrated in the French model could be made applicable in a UK context to provide more company-specific audit reports. An example of a French audit report is provided as Appendix 4.

5.3 In response to the FRC consultation on "Promoting Audit Quality" some institutional investors contended that investor confidence would be enhanced if auditors reported more matters of possible interest to investors — irrespective of whether the matters were disclosed elsewhere. One investor commented "*many investors are surprised that so little is reported*" and cited, as an example of a matter that might be reported, where a company's computer system has reached the end of its operational life and the company has no plans to replace the system. The investor contends that "*including such an item would be fairer to investors and would spur the company into dealing with the issue*"

5.4 Another investor recognised however, that if more entity specific information is to be included in audit reports, *“institutional investors also need to show greater flexibility and openness of mind in looking at audit reports...if audit reports are to be more useful to investors they may need to show shades of grey and investors will need to learn how to regard them”*.

5.5 The suggestion of the institutional investor described in paragraph 5.3 that the auditor’s report should be used to spur management on to address matters that are outside the ambit of the statutory audit may indicate that there continues to be an expectation gap that needs to be closed.

5.6 Reporting such an issue would take the auditor beyond its remit of reporting on the financial statements to, in effect, reporting on the competence of management and the adequacy of the infrastructure that they have installed to run the company. The auditor is not engaged to make such comments. As such comments would entail making judgments that are properly the responsibility of management they may be considered to be a threat to the auditor’s objectivity and independence.

5.7 The AQF paper noted that some of the information that investors identified that they would like to see should be available through the new reporting requirements under IFRSs, enhanced business reviews and the revised Turnbull guidance. In addition and as set out in Appendix 3, the Disclosure and Transparency Rules of the FSA require responsibility statements to be made stating that the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

5.8 The AQF paper concluded that a programme of review of listed companies’ annual accounts should be initiated to assess the extent to which these disclosures go all or part of the way to meeting the wishes of shareholders for further information. It recommends that this review be carried out in mid-2008.

5.9 In response to an extension of its authority the Financial Reporting Review Panel (FRRP) announced in September 2007 that it has started to review the directors’ reports of public and large private companies, as well as their accounts. This will bring the business review within the Panel’s scope for the first time.

5.10 In its consideration of business reviews, the FRRP will take account of a number of factors, including whether:

- The directors’ report contains an explicit cross-reference where a company seeks to satisfy the requirements of the review by incorporating matter elsewhere in the report and accounts.
- The information in the business review is consistent with that disclosed in the accounts, the related notes and with other material included in the Annual Report and, where appropriate, refers to and expands upon, figures reported in the accounts.
- The information in the business review is consistent with that disclosed in the company’s other announcements.
- The business review is balanced and comprehensive in the sense that it deals even-handedly with the positive and negative aspects of the development, performance and position of the business.

- The discussion of the risks and uncertainties facing the company identifies and describes the principal ones.
- The business review includes appropriate analysis using those key performance indicators necessary to provide an understanding of the development, performance and position of the business.

5.11 This Discussion Paper does not address this issue further pending the gathering of information concerning the extent to which disclosures such as the enhanced Business Review are useful to users of annual reports

5.12 The AQF paper also referred to the possible implementation of ISA 706 in the United Kingdom and suggested that it may help to provide the sort of information that investors are looking for. ISA 706 is currently being developed by IAASB and as discussed in paragraph 4.27 the latest Exposure Draft envisages auditors being required to emphasise matters that in the auditor's judgment are of such importance that they are fundamental to the users' understanding of the financial statements.

5.13 However, the proposed ISA envisages that such circumstances would be rare and suggests that a widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters. The APB shares the IAASB's views on this matter.

### **Question 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?





## 6. DISCUSSION QUESTIONS

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

1. Should the auditor's report, as illustrated on pages 19 to 21, 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?
- 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?
- 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?

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

3. Should the auditor's report be split into two parts as envisaged by ISA 700 (Revised)?
- 4(a). Should the auditor's report describe the directors' responsibilities with respect to the preparation of 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?
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?
6. Should the auditor's report refer to the auditor's responsibility to comply with APB's Ethical Standards?
7. Should auditors be required to state in their report, where it is appropriate, that there are no matters that they wish to emphasise?

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

8(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?

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

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

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?

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

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

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 35 to 36 to indicate those elements of an auditor's report that you would like to see included in an unmodified auditor's report.)

### *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?

## **EXTRACT FROM THE COMPANIES ACT 2006**

### **ANNUAL ACCOUNTS**

#### **393 Accounts to give true and fair view**

- (1) The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss —
  - (a) in the case of the company's individual accounts of the company;
  - (b) in the case of the company's group accounts of the undertakings included in the consolidation as a whole, so far as concerns members of the company.
- (2) The auditor of a company in carrying out his functions under this Act in relation to the company's annual accounts must have regard to the directors' duty under subsection (1).

### **APPOINTMENT OF AUDITORS**

#### **493 Disclosure of terms of audit appointment**

- (1) The Secretary of State may make provision by regulations<sup>17</sup> for securing the disclosure of the terms on which a company's auditor is appointed, remunerated or performs his duties.  
Nothing in the following provisions of this section affects the generality of this power.
- (2) The regulations may —
  - (a) require disclosure of —
    - (i) a copy of any terms that are in writing, and
    - (ii) a written memorandum setting out any terms that are not in writing;
  - (b) require disclosure to be at such times, in such places and by such means as are specified in the regulations;
  - (c) require the place and means of disclosure to be stated —
    - (i) in a note to the company's annual accounts (in the case of its individual accounts) or in such manner as is specified in the regulations (in the case of group accounts)
    - (ii) in the directors' report, or
    - (iii) in the auditor's report on the company's annual accounts.

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<sup>17</sup> To date the Secretary of State has neither made nor proposed the regulations that he is permitted to make under this section.

- (3) The provisions of this section apply to a variation of the terms mentioned in subsection (1) as they apply to the original terms.
- (4) Regulations under this section are subject to affirmative resolution procedure.

## **FUNCTIONS OF AUDITOR**

### ***Auditor's report***

#### **495 Auditor's report on company's annual accounts**

- (1) A company's auditor must make a report to the company's members on all annual accounts of the company of which copies are, during his tenure of office —
  - (a) in the case of a private company, to be sent out to members under section 423;
  - (b) in the case of a public company, to be laid before the company in general meeting under section 437.
- (2) The auditor's report must include —
  - (a) an introduction identifying the annual accounts that are the subject of the audit and the financial reporting framework that has been applied in their preparation, and
  - (b) a description of the scope of the audit identifying the auditing standards in accordance with which the audit was conducted.
- (3) The report must state clearly whether, in the auditor's opinion, the annual accounts —
  - (a) give a true and fair view —
    - (i) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year,
    - (ii) in the case of an individual profit and loss account, of the profit or loss of the company for the financial year,
    - (iii) in the case of group accounts, of the state of affairs as at the end of the financial year and of the profit or loss for the financial year of the undertakings included in the consolidation as a whole, so far as concerns members of the company;
  - (b) have been properly prepared in accordance with the relevant financial reporting framework; and
  - (c) have been prepared in accordance with the requirements of this Act (and, where applicable, Article 4 of the IAS Regulation).

Expressions used in this subsection that are defined for the purposes of Part 15 (see section 474) have the same meaning as in that Part.

- (4) The auditor's report —

- (a) must be either unqualified or qualified, and
- (b) must include a reference to any matters to which the auditor wishes to draw attention by way of emphasis without qualifying the report.

#### **496 Auditor's report on director's report**

The auditor must state in his report on the company's annual accounts whether in his opinion the information given in the directors' report for the financial year for which the accounts are prepared is consistent with those accounts.

#### **497 Auditor's report on auditable part of directors' remuneration report**

- (1) If the company is a quoted company, the auditor, in his report on the company's annual accounts for the financial year, must —
  - (a) report to the company's members on the auditable part of the directors' remuneration report, and
  - (b) state whether in his opinion that part of the directors' remuneration report has been properly prepared in accordance with this Act.
- (2) For the purposes of this Part, "the auditable part" of a directors' remuneration report is the part identified as such by regulations under section 421.

### ***Duties and rights of auditors***

#### **498 Duties of auditor**

- (1) A company's auditor in preparing his report must carry out such investigations as will enable him to form an opinion as to —
  - (a) whether adequate accounting records have been kept by the company and returns adequate for their audit have been received from branches not visited by him, and
  - (b) whether the company's individual accounts are in agreement with the accounting records and returns, and
  - (c) in the case of a quoted company, whether the auditable part of the company's directors' remuneration report is in agreement with the accounting records and returns.
- (2) If the auditor is of the opinion —
  - (a) that adequate accounting records have not been kept, or that returns adequate for their audit have not been received from branches not visited by him, or
  - (b) that the company's individual accounts are not in agreement with the accounting records and returns, or
  - (c) in the case of a quoted company, that the auditable part of its directors' remuneration report is not in agreement with the accounting records and returns,

the auditor shall state that fact in his report.

- (3) If the auditor fails to obtain all the information and explanations which, to the best of his knowledge and belief, are necessary for the purposes of his audit, he shall state that fact in his report.

- (4) If —

- (a) the requirements of regulations under section 412 (disclosure of directors' benefits: remuneration, pensions and compensation for loss of office) are not complied with in the annual accounts, or
- (b) in the case of a quoted company, the requirements of regulations under section 421 as to information forming the auditable part of the directors' remuneration report are not complied with in that report,

the auditor must include in his report, so far as he is reasonably able to do so, a statement giving the required particulars.

- (5) If the directors of the company have prepared accounts and reports in accordance with the small companies regime and in the auditor's opinion they were not entitled so to do, the auditor shall state that fact in his report.

## SUMMARY OF RECOMMENDATIONS OF THE AUDIT QUALITY FORUM (AQF)

Recommendation	Paragraphs in this Discussion Paper addressing the recommendation
Early adoption of the audit opinion required by section 495(3) of CA 2006	Chapter 3 paragraphs 3.9 to 3.10
Improving the readability of the auditor's report	Chapter 4 paragraphs 4.10 to 4.19 and paragraphs 4.34 to 4.43  Examples 2 and 3
That the auditor's report include a positive statement concerning the adequacy of accounting records	Chapter 4 paragraphs 4.30 to 4.33
That the auditor's report include a positive statement that there are no matters which the auditor wishes to emphasise	Chapter 4 paragraphs 4.25 to 4.29
Including company specific information within the auditor's report	Chapter 5

## **EXTRACT FROM THE DISCLOSURE AND TRANSPARENCY RULES OF THE UNITED KINGDOM LISTING AUTHORITY AND ARTICLE 4 OF THE TRANSPARENCY DIRECTIVE**

### **Disclosure and Transparency Rules**

4.1.1R Subject to the exemptions set out in DTR 4.4 (Exemptions) this section applies to an issuer:

- (1) whose transferable securities are admitted to trading; and
- (2) whose Home State is the United Kingdom

4.1.5R The annual financial report must include:

- (1) the audited financial statements;
- (2) a management report; and
- (3) responsibility statements.

#### **4.1.12R Responsibility statements**

- (1) Responsibility statements must be made by the persons responsible within the issuer.
- (2) The name and function of any person who makes a responsibility statement must be clearly indicated in the responsibility statement.
- (3) For each person making a responsibility statement, the statement must set out that to the best of his or her knowledge:
  - (a) the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole; and
  - (b) the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

[Note: article 4(2)(c) of the TD]



## **Transparency Directive (Article 4)**

### ***Annual financial reports***

1. The issuer shall make public its annual financial report at the latest four months after the end of each financial year and shall ensure that it remains publicly available for at least five years.
2. The annual financial report shall comprise:
  - a. the audited financial statements;
  - b. the management report; and
  - c. statements made by the persons responsible within the issuer, whose names and functions shall be clearly indicated to the effect that, to the best of their knowledge, the financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view of the assets, liabilities, financial position, and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole and that the management report include a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face. ...

## EXAMPLE OF A FRENCH AUDITOR'S REPORT

### STATUTORY AUDITORS' REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS. For the year ended December 31, 2006

The Statutory Auditors' report includes information specifically required by French law in such reports, whether qualified or not. This information is presented below the opinion on the consolidated financial statements and includes an explanatory paragraph discussing the Auditors' assessments of certain significant accounting and auditing matters. These assessments were considered for the purpose of issuing an audit opinion on the consolidated financial statements taken as a whole and not to provide separate assurance on individual account captions or on information taken outside of the consolidated financial statements. This report should be read in conjunction with, and construed in accordance with, French law and professional auditing standards applicable in France.

In compliance with the assignment entrusted to us by your Annual General Meeting, we have audited the accompanying consolidated financial statements of Peugeot S.A. for the year ended December 31, 2006.

The consolidated financial statements have been approved by the Managing Board. Our role is to express an opinion on these financial statements based on our audit.

#### I. Opinion on the consolidated financial statements

We conducted our audit in accordance with professional standards applicable in France. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the assets and liabilities and of the financial position of the Group as at December 31, 2006 and of the results of its operations for the year then ended in accordance with IFRS as adopted for use in the European Union.

#### II. Justification of our assessments

In accordance with the requirements of Article L.823-9 of the French Commercial Code (*Code de commerce*) relating to the justification of our assessments, we bring to your attention the following matters:

- In the context of our assessment of the accounting principles and methods applied by the Group, we examined the criteria for recognizing development expenditure as an intangible asset and for amortizing said expenditure (note 1.11.A). We also examined the method for determining the revenue related to sales of new vehicles with a buyback commitment (note 1.5A.a).

- As indicated in note 1.10, goodwill is no longer amortized but is tested for impairment at least annually according to the method set out in note 1.13, which is applicable to all long-lived assets. In 2006, the impairment tests led to a €234 million write-down on certain assets of the Automobile Division, including €125.0 million in respect of goodwill allocated to these businesses (notes 8.1 and 8.2), €194 million in respect of assets allocated to two of the Automobile Division's cash-generating units (note 8.3) and €41 million in respect of property, plant and equipment belonging to Peugeot Motorcycles (note 8.4). As part of our assessment of the significant estimates made by management, we verified that this approach complied with IFRS and that the impairment tests described in the notes to the consolidated financial statements were carried out correctly. We also assessed whether the cash flow projections applied and other assumptions used were reasonable. These assessments were made in the context of our audit of the consolidated financial statements taken as a whole, and therefore contributed to the opinion we formed which is expressed in the first part of this report.

### **III. Specific verification**

In accordance with professional standards applicable in France, we have also verified the information given in the Group's management report. We have no matters to report as to its fair presentation and its conformity with the consolidated financial statements.



# **NOTICE TO READERS**

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