



22 November 2013

Our ref: ICAEW Rep 165/13

Professor Arnold Schilder, Chairman, IAASB
545 Fifth Avenue, 14th floor
New York, New York 10017
USA

Dear Arnold

Reporting on Audited Financial Statements: Proposed New and Revised ISAs

ICAEW is pleased to respond to your request for comments on the Exposure Draft *Reporting on Audited Financial Statements: Proposed New and Revised ISAs*.

Please contact me or Katharine Bagshaw (kbagshaw@icaew.com) should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ICAEW RESPONSE TO IAASB ON ITS EXPOSURE DRAFT *REPORTING ON AUDITED FINANCIAL STATEMENTS: PROPOSED NEW AND REVISED ISAs*

Memorandum of comment submitted in November 2013 by ICAEW, in response to IAASB'S exposure draft *Reporting on Audited Financial Statements: Proposed new and revised ISAs* published in July 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft Reporting on Audited Financial Statements: Proposed New and Revised ISA, published by IAASB in July 2013, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Audit and Assurance Faculty is a leading authority on external audit and other assurance activities and is recognised internationally as a source of expertise on audit issues. It is responsible for technical audit and assurance submissions on behalf of ICAEW as a whole. The faculty membership consists of nearly 8,000 members drawn from practising firms and organisations of all sizes from both the private and public sectors. Members receive a range of services including the monthly Audit & Beyond newsletter.

MAJOR POINTS

Global consistency

5. We welcome IAASB's proposals on auditor reporting and acknowledge the very substantial time and effort IAASB has put into developing this exposure draft (ED). In our October 2012 response to IAASB on the consultation paper that preceded this ED¹ we urged IAASB to exercise a leadership role by progressing to an ED, representing the next steps towards a globally consistent audit report. We congratulate IAASB on this achievement but we urge it to redouble its efforts to ensure that ISA 700 is adopted globally. This is critical because global adoption will not happen automatically, and there is a real risk that other major players will go their own way.
6. IAASB has a clear opportunity to consolidate its global standard-setting achievements at this point in time which it must seize. It has made heroic efforts in recent years to develop standards that can be embedded globally and it must ensure that the consensus it has worked so hard to build does not unravel at this critical point. IAASB therefore needs to consider very carefully whether to amend its own proposals in the light of proposals made by others, particularly the EC and the PCAOB, as well as the FRC.
7. The apparent areas of significant difference between the major players are in the definitions of 'key' or 'critical' audits matters, going concern and in the UK, materiality. In some cases a pragmatic decision by IAASB to amend its proposals may help achieve the all-important global consensus it needs. In other cases, it may not, but IAASB must at this point actively consider engaging *directly* with these other players in its deliberations, because some level of public consensus among standard-setters and regulators in this area will go a very long way to avoiding wasteful complexity, expense and duplication in audit reporting in the years ahead.

¹ ICAEW Rep 152/12

8. We emphasise at this point our belief that, going concern and materiality considerations aside, reports prepared under IAASB's and PCAOB's proposals, and the FRC's requirements as they stand, will not in the long run result in any significant differences in what is communicated in audit reports, other than slightly different wording describing the matters in hand. It will be in everyone's interests to be able to assert compliance under the different regimes within the same audit report, and the depth and quality of auditor reporting will be driven less by detailed wording differences in auditing standards, and more by investor demands, the regulatory approach to monitoring auditors, the approach taken by reporting firms, the economic climate, and common practices that develop within and across industry sectors in the next few years. We think it very unlikely that it will become clear that reporting under the IAASB's requirements is superior to reporting under other regimes, or vice versa. The differences in practice will be rendered minimal and the IAASB, as the pre-eminent international body, should take the lead in doing whatever it can to ensure that the differences in ISAs reflect that reality and are similarly minimised.

The EC, PCAOB and FRC

9. We noted in our October 2012 response a particular need to avoid conflicting requirements with and within the European Union. The IAASB must step up its activities in Europe and inject more urgency into its dialogue with the EC and other key players in the trilogue process now under way for the proposed EU legislation on audit. If the EU does not adopt IAASB's proposals or something very similar, not only will a major opportunity for global consistency have been lost, but stakeholder needs are unlikely to be met.
10. Like many others, we are currently working on our comment letter on the PCAOB's proposals and we will reiterate our strong preference for an alignment in auditing standards worldwide. We will emphasise our belief that the PCAOB's proposals as they stand, will not necessarily result in the better quality audit report disclosures that the PCAOB hopes for, by comparison with disclosures under IAASB's proposals. We will recommend that the PCAOB and IAASB align their proposals for audit reporting more closely to eliminate unnecessary wording differences.
11. In the UK, the FRC has chosen to introduce new reporting requirements before an international consensus has emerged. ICAEW is an international body and we have made our commitment to ISAs clear to the FRC. While we think it unlikely that the FRC will adapt its own requirements to match those of the IAASB, we have again made clear to the FRC our serious misgivings about the differences introduced by the FRC and in particular, the value of its requirements to report on materiality. We have also challenged the FRC to make its commitment to ISAs clear by its actions.
12. Our support for IAASB's proposals is not unqualified. We make it clear elsewhere in this response that they could be improved. Despite this, on balance, we think these proposals are workable as they are internationally. However, we reiterate our belief that IAASB must consider the need to make pragmatic changes, if they are necessary to achieve global consistency. Auditors and companies are making these changes for the benefit of investors and it is incumbent on IAASB to do whatever it can to make sure that investors do in fact benefit. Changes will be worthwhile if they avoid the perception that standard-setters have worked in isolation, instead of together, forcing investors to navigate a multiplicity of different audit reports on the same entities. IAASB should consider the need for amendments to achieve global consistency before these requirements are finalised, and it should monitor the effects of implementation and remain open to making further changes thereafter.

Enhanced transparency

13. The changes that will take place in auditor reporting over the next few years are unparalleled. It is important that these changes achieve their objectives of enhanced transparency and better communications between investors and audit committees. A major threat to the achievement of these objectives is that the new audit report disclosures will be irrelevant to investor needs or will degenerate into boilerplate. Behavioural change is needed among all stakeholders. Auditors, audit committees and investors need to step up their level of engagement with each other, and everyone involved in needs to recognise that investors are a

heterogeneous group with a range of information needs. Regulators need to focus on encouraging genuine innovation in communications rather than on sanctioning non-compliance. Changes in auditor reporting standards are only the start and investors need to lead the way by engaging with auditors and audit committees to make their needs known. Auditors and audit committees need to improve their two-way communication processes to ensure the changes deliver the desired transparency.

14. Nevertheless, where businesses do not change significantly which is often the case for smaller listed entities, it is very likely that key audit matters (KAM) will be similar year on year. We indicated in our October 2012 response our belief in the value of such disclosures year on year to reassure on-going investors and to inform new investors. However, the repetition of information available elsewhere to investors, particularly information in publicly-available audit committee reports, will not be well-received. Nor will boilerplate generally. While it is incumbent on audit firms and their lawyers not to write in such a style, regulators, audit committees and investors must not drive the behaviour of auditors towards the use of boilerplate with threats of litigation and regulatory sanctions, or indeed by failing to communicate what they do want.

Smaller listed entities and private companies

15. The success of the changes in reporting that will follow on the adoption of IAASB's final pronouncement will be assessed quickly by stakeholders. There is unquestionably a cost to both audited entities and auditors in producing these enhanced audit reports. Basic economics suggests that costs will be proportionally higher in the audits of smaller listed entities whose stakeholders, in many cases, will be less interested in investing the time and effort required to achieve the benefits of enhanced reporting because they already have the information they need. These pressures may result in audit reports that are of less value because they are less informative and contain more boilerplate. Lower quality audit reports on some smaller listed entities could undermine the success of the initiative as a whole. IAASB needs to manage expectations and recognise that for smaller listed entities, there will be a long learning curve, and that boilerplate will emerge more quickly for the reasons noted above.
16. While the application of the requirements to listed entities is preferable to their application to the wider population of PIEs as a whole, IAASB should not underestimate the number of smaller listed entities that will be caught by these requirements. These include companies with relatively low levels of free float and other privately owned companies that have listed debt instruments for tax management purposes, in which there is no real public interest at all. Whether all listed entities should be classed as PIEs should perhaps be considered at some other time. In the context of these proposals, users of the financial statements of some smaller listed entities will see little value in enhanced auditor reporting. We remain of the firm view that smaller entities generally should be excluded from these requirements to the maximum extent possible. For smaller listed entities such as those noted above, there are often few users of the financial statements. These users already have access by other means to the information they need about the entity, including its audit. In many such cases, the costs of providing information on KAM may well exceed the benefits.
17. That said, in the long run it is inevitable that unlisted entities and their auditors *will* be affected by these requirements, directly or indirectly. The differences between audit reports on listed and unlisted entities may:
- have some effect on the overall desirability or otherwise of an entity being listed;
 - result in pressures on unlisted entities to report voluntarily;
 - affect the dynamics of the audit market, as between firms that are experienced in reporting on listed entities in the required manner, and firms that are not.

We strongly suggest that IAASB monitors these effects, not least because they have implications for future demarcations between listed and unlisted entities in ISAs.

18. Overall, we believe that IAASB has struck the right balance overall with one exception. We agree that requirements to report KAM should be restricted to listed entities and others as determined locally, and that this is more workable than scoping the requirements to cover PIEs. We also agree that where other entities chose to report KAM, that they should be required to follow ISA 701. We remain to be convinced however that there are any significant benefits at all in requiring auditors of all entities (as opposed to listed entities) to communicate significant audit risks and planned significant modifications to the audit approach to those charged with governance. We note, with some concern, the fact that IAASB does not appear to have asked a direct question on this matter.

Going concern

19. We noted in our October 2012 response that there are long-standing calls from investors for clearer auditor reporting on going concern issues, and that we generally support the aim of having auditors comment on the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified. Since then, however, major changes in the reporting of going concern issues by companies have been proposed and there is a strong argument for IAASB to simply wait, or to do only as much as is absolutely necessary, until these issues are at the very least more advanced.

20. The four proposed mandatory statements regarding going concern responsibilities are unobjectionable but they will not come as any surprise to most financially literate users of financial statements. More sophisticated users of financial statements might well appreciate a more nuanced evaluation of the factors affecting the going concern status of a particular entity, but this would currently be a step too far given that the manner in which entities disclose their own going concern status remains so far from being resolved. We remain concerned that where going concern is an issue in an audit, auditors may have difficulties in dealing with the interaction between the mandatory statements, the KAM, and an Emphasis of Matter (EoM). This is an area that warrants further attention by IAASB.

21. It is important that IAASB avoids holding itself and the profession hostages to fortune in this area, by managing expectations. It should making it abundantly clear in the material that accompanies the release of the final pronouncement that:

- the auditor's responsibilities regarding the going concern status of an entity have not changed; and
- important work is currently being undertaken by accounting standard-setters on the disclosures by reporting entities relating to their own going concern status, and that only when the financial reporting issues have been resolved, will (potentially significant) changes be made to the nature and extent of audit procedures performed in this area.

RESPONSES TO SPECIFIC QUESTIONS

Key Audit Matters

Q1: Do users of the audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?

22. Yes, users of audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit *has the potential* to enhance the usefulness of the auditor's report. Auditors are in a better position to report 'key audit matters' than they are 'matters likely to be most important to users' understanding of the audited financial statements or the audit', as proposed previously.

Q2: Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor's judgment in

determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?

23. The proposed requirements in paragraph 8 (a) to (c) - covering significant risks, significant difficulties and changes to the audit approach - constitute a broadly acceptable framework to guide auditor judgement in determining KAM. There will probably be a fair amount of overlap between the three categories, and there will be many calls for further guidance, such as for inclusion of similar criteria to those proposed by the PCAOB, which include matters that created the most difficulties for auditors in forming an opinion, and matters that were reviewed by the engagement quality control reviewer. While auditing standards will help drive the range, depth, consistency, conciseness and overall quality of KAM reported, they are far from the only drivers of auditor behaviour and the approach taken by regulators will be at least as important. There is no reason to think that of themselves, the IAASB's proposed requirements will result in inconsistent auditor judgements, at least in the medium to long term when the requirements have had time to bed in.
24. We note in our major points above our belief that one of the threats to the achievement of the objectives of the proposed changes is repetition in the KAM section of the audit report of material available elsewhere to investors. ISA (UK and Ireland) 700 at paragraph 19(b) notes that matters of audit significance should be reported, *...in a manner that complements the description of significant issues relating to the financial statements, required to be set out in the separate section of the annual report describing the work of the audit committee in discharging its responsibilities* (emphasis added). IAASB might consider including some similar wording for situations in which the audit committee's work described elsewhere in an annual report covers the significant risks and judgements considered by the auditor, and include cautionary working regarding the verbatim or near-verbatim repetition of this or similar material.
25. We note the importance of words in paragraph A1 of ISA 701 suggesting that a relatively small number of matters should be reported compared to the matters communicated with those charged with governance, and words in paragraph A7 suggesting that the greater the number of KAM, the less useful the auditor's communication may be. This is a critical issue and if long lists of KAM are to be avoided, this wording should be blunter. If it cannot be brought into the requirements, it should be emphasised in the material surrounding the publication of the final pronouncement. We note in this context recent observations by the UK's FRC about reporting entities including overly long lists of 'principal risks and uncertainties'. Previous iterations of proposals in this area have included a suggested specific number of KAM to report. While we do not believe that this approach would be helpful, clear statements to the effect that excessively long lists of KAMs are unlikely to be helpful to investors, and that regulators should actively discourage long lists by challenging them, may encourage the desired behaviours.

Q3: Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor's report? If not, why?

26. Paragraph A38 of ISA 701 suggests that for each KAM the following should be included in the audit report: a brief overview of the procedures performed, or the auditor's approach to the matter, or an indication of the outcome of the auditor's procedures. These are all a little vague and a short list such as the following might encourage consistency. The:
- location of the related disclosure;
 - nature of the KAM;
 - audit approach taken;
 - key findings from audit procedures; and
 - why they are considered to be KAM.

Q4: Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking in informational value, and why? Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.

27. These examples are useful for the purposes of generating comment, but they would be better left out of the final pronouncement to avoid, intentionally or otherwise, anchoring auditors to a style of reporting that may, with hindsight, seem restrictive or boilerplate.

Q5: Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why? Are there other practical considerations that may affect the auditor’s ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?

28. We agree with the proposed approach to KAM provided voluntarily. Restrictions on voluntary reporting are generally undesirable but in circumstances such as these, we believe that users of audit reports reading matters under the heading ‘Key Audit Matters’ are entitled to assume that those matters have been selected according to the requirements of ISA 701.

Q6: Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate? (a) If so, do respondents agree with the proposed requirements addressing such circumstances? (b) If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor’s responsibilities under proposed ISA 701 and the determination, in the auditor’s professional judgment, that there are no key audit matters to communicate?

29. Yes, it is appropriate for ISA 701 to allow for the possibility that there be no KAM, subject to the requirements proposed.

Q7: Do respondents agree that, when comparative financial information is presented, the auditor’s communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?

30. Yes, when comparative information is presented KAM should be limited to the audit of the most recent period’s financial statements.

Q8: Do respondents agree with the IAASB’s decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate, and how such concepts have been differentiated in the Proposed ISAs? If not, why?

31. Yes, there is still a need for Emphasis of Matter and Other Matter paragraphs although the interaction between them and KAM is likely to be messy where they cover the same ground. IAASB should consider the possibility of requiring auditors to deal with such matters under a single heading such as ‘Key Audit Matter and Emphasis of Matter’, for example, rather than dealing with them more than once.

Going concern

Q9: Do respondents agree with the statements included in the illustrative auditor’s reports relating to: (a) The appropriateness of management’s use of the going concern basis of accounting in the preparation of the entity’s financial statements? (b) Whether the auditor

has identified a material uncertainty that may cast significant doubt on the entity's ability to concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised)? In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.

- 32.** As noted in our main points above, there is a strong argument for waiting until current financial reporting issues under discussion have been resolved before making auditor reporting changes. There is also more work to be done on the interaction between KAM, EoM and the mandatory statements when going concern issues do arise to avoid repetition of going concern problems in three places in the auditor's report. Nevertheless, the proposed statements are unobjectionable, if unremarkable. Both paragraphs under the going concern heading in the proposed report cover management and auditor responsibilities. At present, the first sentence in the second paragraph jars with the last sentence with the first paragraph, and while swapping these two sentences around would disrupt the flow of subject matter, we suggest that it would be a marginally easier read.
- 33.** Regardless of the wording used, it is inevitable that some users of financial statements will, intentionally or unintentionally, misunderstand or misinterpret the proposed statements. Educating users about the uncertainties attaching to the going concern assumption is an on-going process in which IAASB (and IFAC) might well consider taking a more high-profile role internationally. At some point in the future, it may be possible to make the more nuanced statements that some investors would like but to do so now in the absence of appropriate parallel changes in financial reporting, would be very likely to cause a high level of confusion.

Q: 10 What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?

- 34.** We find the proposed statement to the effect that neither management nor auditors can guarantee the entity's ability to continue as a going concern unobjectionable. However, management controls the entity and to that extent it has some degree of influence over its going concern status. The same is not true of auditors and for this reason there is a case for removing the reference to management from the auditor's report and referring to its inclusion as a separate statement by the directors elsewhere in the annual report.

Compliance with independence and other relevant ethical requirements

Q11: What are respondents' views as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?

- 35.** The possession of esoteric knowledge is no longer the hallmark of a professional. There are increasing expectations generally that, if they so wish, users of reports prepared by professionals will be able to access the full text of the standards under which the professionals they employ, operate. Educating users of financial statements has to involve facilitating this process and the proposed requirement to disclose the source of independence and other ethical requirements is therefore welcome. IAASB should consider emphasising this matter when issuing its final pronouncement. In the vast majority of cases, these requirements are unlikely to cause auditors any problems.

Disclosure of the name of the engagement partner

Q12: What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?

36. Under the Statutory Audit Directive in the EU, the name of the audit partner is already disclosed with an exemption similar to the exemption described by IAASB. We have not observed any significant effects following the introduction of this requirement

Other improvements to proposed ISA 700 (revised)

Q13: What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?

37. Paragraph 102 of proposed ISA 700 describes changes to the nature of and manner in which auditor and management responsibilities are disclosed in the auditor's report. We noted in our October 2012 response our belief that this type of boilerplate is best relegated to an appendix or web-site, and that website link approach has worked well in the UK. It is possible that in the fullness of time, the boilerplate disclosures regarding the going concern status of the entity may be similarly relegated.

Q14: What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20–45 and the circumstances addressed in paragraphs 46–48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?

38. Proposals that purported to mandate the ordering of sections in the report would not be workable as they would conflict with national legislation. The proposed requirements, which effectively require the proposed order to be used where there are no such national requirements, are appropriate.

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