James Gunn
Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue
6th Floor
New York
NY 10017
USA

19 October 2012

Dear James

Improving the auditor's report

The Financial Reporting Council (FRC) welcomes the opportunity to comment on the IAASB's Invitation to Comment: "Improving the Auditor's Report". The FRC is strongly supportive of the aims of the IAASB's initiative as it too is acutely aware of demand from investors, and other users, to close the so-called information gap relating to insights about the Company and its financial information and about the audit from the perspective of the auditor.

In part, these demands reflect declining investor confidence both in the audit and in corporate reporting. A requirement for the auditor to publicly report on matters of interest to investors and other users is seen by many investors as having the potential to play a part in stemming this decline. Such a requirement may also provide the auditor with a lever to incentivise directors themselves to provide more focused and insightful corporate reporting where the 'nuclear deterrent' of a qualified auditor's report or the 'rare' and 'fundamental' emphasis of matter would not have been appropriate.

Making the auditor's insights about the entity and its financial information more transparent, whether such insights are reported by the directors or the auditors, may also provide pointers to matters on which investors would wish to engage with the audit committee or other directors. Making the key audit judgments more transparent may lead to greater understanding by investors of whether auditors are addressing the matters investors perceive to be important in relation to a particular audit. This may again provide a basis for engagement by investors.

It should not be inferred that we believe that greater transparency about the auditor's insights and judgments would be sufficient to enable investors to judge the quality and effectiveness of the audit. That would likely require a level of disclosure that would be both impractical to produce and unlikely to be read by investors. The work of the audit committee in overseeing the effectiveness of the audit will, therefore, continue to be important in this respect. Nonetheless, we believe that greater insight into the auditor's approach and judgments has the capacity to enhance confidence in the audit.

In order to develop this response, we undertook extensive outreach activities amongst our stakeholders. For this purpose we developed an illustrative improved UK auditor's report, which has regard to the proposed IAASB auditor reporting model and includes a number of additional features that we wished to discuss with stakeholders. The latest draft of this report, reflecting the feedback we received from stakeholders, is included at Appendix 2 to this letter. The principal changes from the IAASB's illustrative improved auditor's report are described in more detail in this letter.

In addition, at Appendix 3 we have annotated a marked up copy of the IAASB's illustrative improved auditor's report to identify the reasons for each of the changes we have made to it in arriving at the latest draft of the illustrative UK report at Appendix 2. We have also attached as Appendix 4 an illustrative draft 'Scope of Audit' document which contains a fuller description of an audit than that set out in the 'Auditor Responsibility' section of the draft auditor's report in the ITC. The illustrative documents in Appendices 2, 3 or 4 are purely illustrative. None of them has been subject to the FRC's full due process (including formal public consultation with stakeholders, obtaining the formal advice of the Audit and Assurance Council and the approval of the FRC Board) which would be required before any of them could be implemented.

An important difference between the IAASB illustrative report and the one that we developed (at Appendix 2) arises from the conclusion that we reached that commentary about the audit should be the domain of the auditor and included within the auditor's report. In this regard we considered that the proposals of the IAASB in this regard needed considerable strengthening such that the auditor would be required to provide a commentary on the following three matters about the audit:

- The auditor's assessment of which risks were significant to the audit;
- The auditor's assessment of materiality; and
- An overview description of the scope of the audit (which could incorporate, for example, "the involvement of other auditor's" paragraph set out in the IAASB's example).

We found strong support from investors for the auditor providing commentary along these lines.

To provide commentary that will be valued by users of financial statements, audit engagement partners will need to exercise good judgment and have the courage to carry it through. This may require them to take some risks. Strong support for them from the leadership of audit firms and from auditors' professional bodies will be critical. This should enable them to seize the opportunity to demonstrate their commitment to serving the interests of investors by identifying and promoting frank disclosure of the issues they identify in the audit that they believe will be relevant to investors in appraising the governance and performance of the companies in which they have invested.

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The UK response to closing the information gap – "Effective Company Stewardship"

The FRC has developed, and recently implemented, its "Effective Company Stewardship" ("ECS") model, which responds to similar user demand for improvements in the disclosure of information that makes transparent the auditor's insights into the entity, and its financial information, and into the audit.

The IAASB is seeking to close the information gap primarily through the mechanism of the auditor providing within the auditor's report a commentary which is intended to enhance the informational value of the auditor's report. However, because the FRC's remit is wider than the auditing standards, we have not been constrained to advance a solution exclusively through improvements to the auditor's report.

Under the FRC's ECS model, ISA (UK and Ireland) 260 has been revised to expand the nature and extent of the report provided by auditors to Audit Committees. The intention is to refocus the auditor on providing the audit committee with the auditor's insights arising from the audit about the company, its financial statements and the audit that are relevant to the directors' corporate reporting responsibilities set out in the UK Corporate Governance Code, as enhanced under ECS.

These enhanced responsibilities include the Board: confirming that the annual report and financial statements taken as a whole are fair balanced and understandable; and providing a separate section in the annual report describing the work of the audit committee. This section of the annual report is intended to include a description of the significant issues the audit committee considered in relation to the financial statements and how they were addressed. In developing these disclosures, the audit committee would have regard to the matters communicated to it by the auditor. The annual report would, therefore, include similar information to that which the IAASB envisages being included in the auditor commentary in the auditor's report.

ISA (UK and Ireland) 700 has been revised, amongst other reasons, to require the auditor's report to include any information communicated by the auditor to the audit committee, that in the auditor's judgment should have been disclosed by the Board of Directors in the Annual Report.

The FRC believes that a particular benefit of its ECS model is that the primary responsibility for disclosing information about the audited entity, other than in exceptional cases where directors fail to fulfil their responsibilities, remains with the directors. As a result, there is less risk that the directors' primary responsibility for reporting on their stewardship of the company will be undermined. Nonetheless, the constructive tension, that results from giving auditors the responsibility to report publicly if they are not satisfied that the directors have fully met their reporting responsibilities, has the potential to enhance the quality of corporate reporting without auditors always having to include additional information in their auditor's reports.

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Is global consistency in auditor's reports necessary?

The FRC strongly supports global consistency in the application of the operational ISAs. However, subject to the inclusion in the auditor's report of certain defined minimum elements, we do not believe that global consistency in the form and structure of the auditor's report is either necessary or desirable, primarily because in some jurisdictions the auditor's responsibilities go beyond those implicit in the ISA audit. In those circumstances, in order to be relevant to investors, the auditor's report needs to be responsive to the unique scope and reporting requirements of the jurisdiction.

Our outreach activities, in connection with developing this response, have revealed strong support amongst investors in UK companies (as well as many other stakeholders) for the adaptive changes we have made to the IAASB's illustrative improved auditor's report included in the ITC. We consider that these changes are necessary in order to be responsive to the scope and reporting requirements of an auditor in our jurisdiction.

In the United Kingdom, for example:

- The auditor is not permitted to limit its opinion on whether the financial statements give a true and fair view (i.e. is not able to state that the financial statements give a "true and fair view in accordance with IFRS");
- There are a number of reporting requirements with respect to going concern and directors remuneration disclosures arising from the Listing Rules and investors want these integrated with any reporting requirements that arise from a pure ISA audit;
- The ECS model seeks to close the information gap primarily through enhanced disclosures by those charged with governance, informed by enhanced auditor communications to them from the auditor, rather than through the provision of direct auditor commentary (except where directors do not meet their enhanced reporting responsibilities). Therefore, investors in our jurisdiction want the auditor to be able to cross-refer to appropriate disclosures made by the directors about the entity and its financial statements rather than directly disclosing the same information again in the auditor's report; and
- Public Sector auditors also have to express their opinion on regularity, which is fundamentally different from their opinion on the financial statements, and that opinion is seen to be at least as important as the opinion on the financial statements and to require at least as much prominence in the auditor's report.

We are aware of other similar national scope and reporting differences, such as those arising from the French "Justification of Assessments" model.

Insisting on a move away from the current ISA 700 model (paragraph 43 of which includes important discretion to accommodate national or regional legal and regulatory differences in auditor scope and reporting requirements) to one which requires global rigidity in the form and structure of auditor's reports (as has been suggested by some) may give rise to irreconcilable conflicts between the requirements of the reporting ISAs and the requirements of national laws and regulations that cannot submit to the sovereignty of the ISAs. This

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would in our view unnecessarily prevent a jurisdiction whose auditing standards comply wholly with the operational standards from asserting compliance with the ISAs unless it were to conform its national law and regulations to the specific scope and reporting requirements of the ISAs in all respects.

At present, the FRC has adopted ISA 700 as issued by the IAASB, exercising the discretion permitted by paragraph 43 to accommodate scope and reporting requirements that emanate from laws and regulations in the UK and Ireland such as those referred to above. We, therefore, very much hope that equivalent discretion will be retained and built upon in the revised ISAs that emerge in the light of responses to the ITC. Such discretion should, among other things, enable other approaches to closing the information gap, such as our governance driven ECS model, so long as it can be demonstrated that there are adequate safeguards to ensure that the equivalent information would either be adequately disclosed by the directors or that the auditor would be required to make good any such disclosures that it considered inadequate.

Improving the structure of the Illustrative Auditor's Report

We have undertaken considerable out-reach activities with UK and Ireland stakeholders with respect to the IAASB's ITC, focusing in particular on how these proposals can be reconciled with our ECS model. In doing so, we have explored the implications for the illustrative improved auditor's report in the ITC. Whilst we have found much support for the aims of the IAASB's initiative, a significant number of those whom we have consulted have expressed concerns about aspects of the structure of the proposed report, as well as making suggestions for improvement, which included the following:

Distinguishing Opinions and Conclusions from Commentary
There is broad support for the proposal to include in the auditor's report conclusions on the going concern status of the entity and about the Other Information, that are respectively subsidiary or ancillary to the audit opinion and arise from the audit work done to meet the scope of the audit set out in the ISAs, as well as for the concept of 'auditor commentary'. There is, however, some concern that the conclusions on going concern and Other Information may be seen as standalone opinions on these matters and that auditor commentary may be interpreted as piecemeal opinions.

The suggestion was that the risk of such misinterpretation may be lessened if these conclusions were to be placed immediately following the opinion (and basis for opinion) paragraphs. This would, in effect, create a section of the report that includes the opinion on the financial statements and certain subsidiary and ancillary conclusions arising from the audit work. Compared with the illustrative improved auditor's report in the ITC, this would involve bringing the conclusion on Other Information earlier in the report.

It was suggested that this would also establish a clearer separation between the opinion and conclusions on the one hand and the auditor commentary section on the other (the going concern and Other Information conclusions sandwich the auditor commentary, in the

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illustrative report in the ITC) and therefore signal more clearly to a reader that the auditor commentary is not intended to be in the nature of standalone opinions or conclusions.

Cutting clutter from the auditor's report

There continues to be very strong support from UK stakeholders for the removal of as much standardised language as possible from the auditor's report. This comment was most frequently made in the context of the improved standardised language regarding the description of the scope of an audit and the responsibilities of directors and auditors. UK stakeholders to whom we spoke (whether corporate, investor or auditor), were virtually unanimous in believing that such text should ideally be removed from the auditor's report and included in the Scope of Audit document, which is retained on our website and to which the UK and Ireland auditor is permitted to cross refer in the auditor's report, or at least be included at the very end of the auditor's report as part of a third 'reference section'.

When the Clarity ISAs were introduced in the UK and Ireland, we responded to similar feedback from stakeholders by reducing the standardised language in the auditor's report where possible. This included omitting from the required language of the ISA (UK and Ireland) 700 auditor's report text equivalent to that in the last sentence of the basis of opinion paragraph in the illustrative improved auditor's report in the ITC and permitting a cross reference to a Scope of audit document held on our website. There was support for continuing to maintain these features of the auditor's report.

There was nonetheless strong support for the improved language of the description of the auditor's responsibilities included in the ITC - the concerns were a question of placement. There is a strong body of support in the UK for increasing the relevance of both corporate reports and auditor's reports by not allowing standardised or 'boilerplate' language to 'clutter' such communications. Where such language is important context, it should be made accessible to the reader as a reference resource (we have illustrated this in Appendix 4).

Emphasis of matter paragraphs

We heard concern about the proposed absorption of the traditional emphasis of matter paragraph within the concept of auditor commentary. Even though the use of such paragraphs is, by design, rare (and even more so when going concern emphasis of matter paragraphs are excluded), the concern of both investors and auditors was that using an auditor commentary paragraph to emphasise a pervasive or fundamental issue of importance would not have the same impact and that its importance may be hard to convey. Some commentators thought that emphasis of matter paragraphs should therefore be retained and that in the 'improved' auditor's report they would fit most appropriately in the opinions and conclusions section (see above) after the opinion and basis for opinion. We support this view.

Going concern

There is broad agreement that a conclusion about going concern should be given by the auditor. However, there was considerable concern about the risk of misinterpretation of the conclusion about the appropriateness of the going concern assumption, if it were to be included in the auditor's report. The language of that conclusion in the ITC reflects the

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language of ISA 570 but it is highly 'coded'. Put simply, it is intended to mean that under the accounting framework adopted it is appropriate for the accounts to be drawn up on the going concern basis of accounting.

As has been highlighted by the Sharman Inquiry[1] in the UK, there is an extremely high threshold for departing from the going concern basis of accounting. This is essentially only permitted when liquidation of the entity is either planned or imminent and virtually certain. In light of this, the point has been made strongly that there is relatively little value in this conclusion. This conclusion will often remain true even when the entity is experiencing significant financial or economic distress, including when the directors and auditors have reported that there are material uncertainties.

On the other hand, the reference in the proposed language of this conclusion to the appropriateness of the going concern assumption may well be taken (from a natural reading of the text) to imply that it is reasonable to assume the entity is solvent and will be able to meet its liabilities as they fall due when this may not be the case.

Accordingly, we believe this conclusion should not be included in the auditor's report.

In the UK and Ireland, directors of companies that are obliged or voluntarily elect to comply with the UK Corporate Governance Code, or to explain why they have departed from it, state whether or not they believe that the Company is a going concern and the auditor reviews the work done by the directors in arriving at their conclusion. The auditor has to report if they identify anything from their review that calls into question the directors' statement. The feedback we received from stakeholders was that if the auditor is to include a conclusion arising from its work on going concern, that conclusion should address all of the auditor's responsibilities in one place in the auditor's report.

Accordingly, we believe that the auditor's report for an entity that is required or chooses to comply with the UK Corporate Governance Code would need to include in the auditor's report not only the conclusion it draws on material uncertainties but also its conclusion on the directors' statement about whether the entity is a going concern. This latter item is more overarching than the conclusion on material uncertainties and we therefore believe this should come before the conclusion on material uncertainties.

Finally, in relation to the proposed conclusions on going concern, in line with the comments we received on cutting clutter, there was a preference for not including in the auditor's report the last sentence of the second paragraph on going concern in the illustrative example in the ITC: '*Because not all future events or events or conditions can be predicted, this statement is not a guarantee as to the Company's ability to continue as a going concern.*'. If this is to be retained, it should be included in the Scope of audit document (see Appendix 4). The point was also made that if it were to be included in the auditor's report as illustrated in the ITC, it would be unclear whether it was intended only to address the 'statement' about material uncertainties or the one about the going concern assumption or both.

[1] See: http://frc.org.uk/Our-Work/Headline-projects/The-Sharman-Inquiry.aspx

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Other opinions and conclusions relating to Other Information

The auditor's opinions on certain elements of the Other Information and the auditor's reports by exception – on matters relating to: the keeping of books and records by the entity; the adequacy of information and explanations received by the auditor; and certain statements required to be made by the directors about their governance of the entity, required by the companies acts and the Listing Rules – should be included in the suggested opinions and conclusions section of the auditor's report and not included in a separate section at the end of the auditor's report.

Regularity opinion in a public sector auditor's report

Where required, the report on regularity in a public sector auditor's report should also be included in the suggested opinions and conclusions section of the auditor's report not in a separate section at the end of the auditor's report. It is of at least equal relevance and importance to users of a public sector auditor's report as the opinion of the financial statements.

Insights into the audit

There was virtually unanimous preference amongst those we met in our outreach programme for the ECS model of reporting, as compared to the proposed auditor commentary direct reporting approach reflected in the ITC. A key driver of that preference was the view that disclosure about the company and its financial information should remain the primary responsibility of the directors and that the auditor should therefore only have a responsibility to provide such information if the directors were not to meet their responsibility to do so.

In that context, we also explored whether, given that information about the audit itself (such as the decisions the auditor makes about materiality, significant risks and the scoping of the audit) is primarily within the domain of the auditor, disclosures about such matters should be the primary responsibility of the auditor. There was strong support from investors for auditors to provide the sort of information about these matters that we have illustrated in the example in Appendix 2, so long as this information is provided on an entity specific basis and without resorting to standardised explanatory material. Where necessary, the preference was to include relevant standardised explanatory material in the Scope of Audit document maintained on the FRC's web-site, to enable appropriate cross-referencing from the auditor's report.

In contrast, support for providing information about the audit was at best mixed amongst auditors and preparers, who frequently questioned the value to users and highlighted the potential for misinterpretation unless the explanations were extensive. However, we found that investors think such disclosures would be valuable in providing some insight into the audit, would enable a degree of comparison between different audits and may provide a basis for engagement about the audit with the Audit Committee or, potentially, the auditors. Accordingly, the FRC believes that auditors should provide such information in the auditor's

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report and will be seeking to encourage auditors to do so in the implementation of the ECS model.

Consolidating the comments that we received through our outreach would lead to an auditor's report consisting of three principal sections depicted in the following diagram:

I. Opinions and conclusions

- **Opinion on the financial statements**
- **Emphasis of matter (if applicable)**
- **Basis for opinion on the financial statements**
- **Opinions on matters prescribed by the Companies Act 2006**
- **Conclusions relating to going concern**
- **Conclusions arising from our reading of the Annual Report**
- **Other matters on which we are required to report by exception**

(In an unmodified report, this section would be standardised. In a modified report, or one where exceptions are reported this section would also include engagement specific material.)

II. Auditor Commentary

- **Significant matters arising from our audit**
- **Our assessment of materiality**
- **The scope of our audit (including the risks identified as being significant to our audit)**

(This section would be entity specific)

III. Scope of Audit

- **Responsibility of Directors for the Annual Report and Financial Statements**
- **Auditor's Responsibility**

(This section would be standardised and could either be included at the end of the auditor's report in a separate section or largely included on the standard-setter's web-site.)

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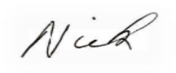
Further elaboration of our comments

Our responses to the detailed questions set out in the ITC follow in Appendix 1. As explained above, we have included as Appendix 2 an illustrative improved auditor’s report which has been modified to reflect UK laws and regulations and the various recommendations that we have made in this letter.

If it would be helpful we would be pleased to elaborate on our comments and our responses to your questions with you at your convenience.

Yours sincerely



Nick Land
Director of the FRC and Chairman of the FRC’s Audit & Assurance Council

Enquiries in relation to this letter should be directed to Marek Grabowski, Director of Audit Policy.
DDI: 020 7492 2325
Email: m.grabowski@frc.org.uk

About the FRC
The Financial Reporting Council is the UK’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. We promote high standards of corporate governance through the UK Corporate Governance Code. We set standards for corporate reporting and actuarial practice and monitor and enforce accounting and auditing standards. We also oversee the regulatory activities of the actuarial profession and the professional accountancy bodies and operate independent disciplinary arrangements for public interest cases involving accountants and actuaries.

Appendix 1 – Responses to the specific questions raised in the Invitation to Comment

Overall Considerations

1. ***Overall do you believe the IAASB's suggested improvements sufficiently enhance the relevance and informational value of the auditor's report, in view of possible impediments (including costs)? Why or why not?***

   Although we fully support the aims underlying the IAASB's suggested improvements we do not believe that the hoped for improvements will fully satisfy the information and other needs of investors and other users. More specifically:

   - We question whether the proposals for auditor commentary meet fully the aspirations of investors (see response to question 5).
   - In respect of going concern we believe the proposals (particularly the inclusion of a conclusion on the appropriateness of adopting the going concern basis of accounting) to be more likely to perpetuate rather than close the expectation gap surrounding the going concern status of the entity (see response to question 8).
   - Whilst we agree that the responsibilities are better explained, we do not support a responsibilities section of such length in an auditor's report as this section provides generic information that is applicable to all audits rather than decision useful information that is specific to the audited entity. We believe the responsibilities should be described either on a web page that is cross referred to from the auditor's report or in a separate attachment to the report (see response to question 11).

2. ***Are there other alternatives to improve the auditor's report, or auditor reporting more broadly, that should be considered by the IAASB, either alone or in coordination with others? Please explain your answer.***

   In the context of the IAASB's remit we are not aware of alternative approaches that the IAASB might adopt. We describe our governance driven approach to improving the auditor's report in our covering letter. See also our response to Question 3.

   However, in the context of our comments on going concern with respect to question 8 we would encourage the IAASB to work with the IASB and others to improve disclosures in financial statements with respect to going concern. The FRC published guidance for directors on going concern and liquidity risk in 2009. This guidance will shortly be updated to reflect the recommendations of the Sharman Inquiry. We would be pleased to provide a copy of our 2009 Guidance to you and also to discuss with you the developments we expect to be reflected in the forthcoming revision.

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Appendix 1 – Responses to the specific questions raised in the Invitation to Comment

Auditor Commentary

3. ***Do you believe the concept of Auditor Commentary is an appropriate response to the call for auditors to provide more information to users through the auditor's report? Why or why not?***

   As explained in the covering letter, the tenet of the FRC's approach to closing the information gap under the Effective Company Stewardship (ECS) model[2] is to require the auditor to communicate to the audit committee the rationale and the supporting evidence the auditor has relied on when making significant professional judgments in the course of the audit and in forming its opinion on the financial statements. The Board reports on these matters in the annual report and the auditor includes information it has previously reported to the audit committee in the auditor's report only when such information has not been appropriately disclosed by the Board in the Annual Report.

   We believe that the directors have and should continue to have primary responsibility for disclosing information about the entity and that such information is best disclosed by them to avoid undermining that responsibility. However, we believe that information about the audit lies primarily in the auditor's domain and that disclosure of information about the audit may, therefore, be best included within the auditor's report.

   However, we appreciate that the IAASB cannot mandate enhanced reporting by the entity and in that context believe that auditor commentary, as described in the ITC, is in principle an appropriate response to close the information gap.

   Nonetheless, we do not support the idea suggested in paragraph 42 of the ITC that there may no longer be a need to retain the separate concept of Emphasis of Matter (EOM) Paragraphs. In our outreach activities a consistent message that we have heard is that it is necessary to retain EOM paragraphs in order to facilitate a gradation of auditor commentary (i.e. to be able to highlight critical issues in contrast to merely interesting issues) – see further comments in our covering letter. The need for EOM paragraphs is seen not only with respect to going concern where we have a number of reservations concerning the IAASB's proposals (see responses to question 8 below) but also in relation to other, potentially less frequently arising issues.

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[2] The FRC's changes to the UK Corporate Governance Code and auditing standards, and related guidance, to implement its Effective Company Stewardship proposals were published on 28 September 2012 and can be found at http://frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx and http://frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-issues-revised-auditing-standards-to-enhance-c.aspx.

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4. ***Do you agree that the matters to be addressed in Auditor Commentary should be left to the judgment of the auditor, with guidance in the standards to inform the auditor's judgment? Why or why not? If not, what do you believe should be done to further facilitate the auditor's decision-making process in selecting the matters to include in Auditor Commentary?***

   We strongly agree that the matters to be addressed in Auditor Commentary should primarily be left to the judgment of the auditor with guidance in the standards to inform the auditor's judgment. However, we believe that the standard should encourage auditors to think beyond any minimal list of considerations that the standard indicates the auditor should take account of in making its judgment. An example of a minimal list of considerations that meets these criteria is provided in paragraph 16-1 of ISA (UK and Ireland) 260.

   The IAASB should avoid any temptation to develop more extensive guidance that could easily be transformed into a checklist. The development of checklists would merely serve to remove the need for auditors to exercise judgment with respect to choosing the matters that are included in the commentary.

5. ***Do the illustrative examples of Auditor Commentary have the informational or decision-making value users seek? Why or why not? If not, what aspects are not valuable, or what is missing? Specifically what are your views about including a description of audit procedures and related results in Auditor Commentary?***

   Based on what we have heard during our outreach activities, we do not believe that the illustrative examples of auditor commentary have either the informational or decision making value that users are seeking.

   Addressing each category of auditor commentary we would comment:

   <u>Signposting a single disclosure in the financial statements (example 1)</u>: We did not find any support whatsoever for commentary of this nature. Users did not consider that the auditor's report should be used to provide them with a "roadmap" for reading the annual report. Many users considered that they were capable of navigating the annual report themselves. A particular criticism of this example was that it gave the appearance of being an emphasis of matter paragraph despite the fact that this is not the intent of making the comment. Many users and auditors with whom we discussed the illustrative auditor's report expressed quite strong views that emphasis of matter paragraphs should be retained.

   <u>Summarizing key points regarding disclosures and other information (example 2)</u>: Although this example attracted more support from users than example 1 it was nevertheless criticised for not providing sufficient information: especially concerning the meaning of "marginal". Consequently, the information provided was regarded as being interesting but not decision useful.

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<u>Reference to financial statement disclosures and description of audit procedures (example 3)</u>: This example was regarded as being unhelpful to users because information that management's recorded amount fell within the auditor's range is unhelpful unless the magnitude of the auditor's range is disclosed. Users also commented that they would much prefer information about how far the entity's valuation is from the "tipping point" of being unacceptable to the auditors.

<u>Matters related to the overall audit strategy (examples 4 and 5)</u>:
Example 4 attracted little interest from users. Investors, in particular were unsure what they were supposed to do with this information.

Example 5 was seen as providing useful information by a number of users. However, as explained in the covering letter the FRC takes the view that the "involvement of other auditors" should form a part of fuller disclosures by the auditor of the scoping of the audit and the auditor's assessment of materiality.

6. ***What are the implications for the financial reporting process of including Auditor Commentary in the auditor's report, including implications for the roles of management and those charged with governance (TCWG), the timing of financial statements and costs?***

   There was virtually unanimous preference amongst those we met in our outreach programme for the ECS model of reporting, as compared to the proposed auditor commentary direct reporting approach reflected in the ITC. A key driver of that preference was the view that disclosure about the company and its financial information should remain the primary responsibility of the directors and that the auditor should therefore only have a responsibility to provide such information if the directors were not to meet their responsibility to do so.

   In that context, we also explored whether, given that information about the audit itself (such as the decisions the auditor makes about materiality, significant risks and the scoping of the audit) is primarily within the domain of the auditor, disclosures about such matters should be the primary responsibility of the auditor. There was strong support from investors for auditors to provide the sort of information about these matters that we have illustrated in the example in Appendix 2, so long as this information is provided on an entity specific basis and without resorting to standardised explanatory material. Where necessary, the preference was to include relevant standardised explanatory material in the Scope of Audit document maintained on the FRC's web-site, to enable appropriate cross-referencing from the auditor's report.

   In contrast, support for providing information about the audit was at best mixed amongst auditors and preparers, who frequently questioned the value to users and highlighted the potential for misinterpretation unless the explanations were extensive.

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However, we found that investors think that such disclosures would be valuable in providing some insight into the audit, would enable a degree of comparison between different audits and may provide a basis for engagement about the audit with the Audit Committee or, potentially, the auditors. Accordingly, the FRC believes that auditors should provide such information in the auditor's report and will be seeking to encourage auditors to do so in the implementation of the ECS model.

There are likely to be time and cost implications that arise from the inclusion of auditor commentary in the auditor's report. The cost implications of initially preparing and drafting the commentary should be relatively insignificant as the matters discussed therein are likely to have been the subject of discussion with management and the audit committee. However, the audited entity and its advisers will likely wish to negotiate the content of the commentary with the auditor. Where particularly contentious matters are dealt with in the commentary the auditor may wish to consult with its own legal counsel with respect to content and wording.

Although it seems inevitable that there will be additional cost associated with the provision of auditor commentary the FRC does not believe that this should be an impediment to the provision of such commentary. Rather, this cost should be seen as a consequence of improving the communicative value of auditor's reports to investors and others.

7. ***Do you agree that providing Auditor Commentary for certain audits (e.g., audits of public interest entities (PIEs)), and leaving its inclusion to the discretion of the auditor for other audits is appropriate? Why or why not? If not, what other criteria might be used for determining the audits for which Auditor Commentary should be provided?***

In principle the provision of auditor commentary is likely to be useful in the context of most audits. However, our current approach to ECS is to apply its requirements only to those entities who are either required or voluntarily choose to follow the UK Corporate Governance Code. The FRC believes that companies and auditors will need a period of experimentation with its new ECS proposals. Once experience has been gained the FRC will consider whether the requirements should be extended to other categories of entity. Our approach, therefore, is broadly consistent with the view expressed in the question with which, therefore, we agree.

Going Concern/Other Information

8. ***What are your views on the value and impediments of the suggested auditor statements related to going concern, which address the appropriateness of management's use of the going concern assumption and whether material uncertainties have been identified? Do you believe these statements provide useful information and are appropriate? Why or why not?***

We are aware of the concerns which have been widely expressed that in the recent financial crisis many financial institutions reported financial distress and the need for

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emergency financing only weeks after receiving unmodified auditor's reports. Many commentators have associated these circumstances with inadequate reporting of going concern difficulties by both financial institutions and their auditors.

Although the FRC shares the concerns that have been expressed by investors and other commentators we have significant reservations about whether the suggested auditor statements relating to going concern will improve the situation. During our outreach activities we have heard views from a number of users that the proposed disclosures are, in fact, likely to perpetuate the expectation gap with respect to going concern.

Our principal concern is with the expression of the conclusion that management's use of the going concern assumption in the preparation of the financial statements is appropriate. Many readers of financial statements will be unaware that:

- there are very few circumstances where it is inappropriate under accounting standards for this statement to be made; and
- that such a conclusion is not a conclusion about the viability of the entity.

Hence the making of this statement may lead investors and other users of financial statements to conclude that an auditor is asserting that an entity is viable when this is not in fact the case. The FRC is strongly of the view that this conclusion should not be expressed in the auditor's report (see further discussion of this issue in our covering letter).

The FRC believes that responsibility for explaining whether or not an entity is a going concern and whether its business model is viable lies primarily with those charged with governance. Unfortunately, accounting standards generally are rather silent on this subject and as a consequence those charged with governance are neither required nor guided to provide such explanations. In the UK we have provided guidance for directors in this regard (see also our comments about the need, in the UK and Ireland, to integrate the auditor's conclusion on the directors' statement on going concern with the IAASB proposed conclusion on material uncertainties).

The expression of the auditor's conclusion regarding material uncertainties relating to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern is important. However, the FRC is strongly of the view that:

- To support such reporting by auditors, accounting and auditing standards need to be improved to provide a common understanding of what is meant by the expression "material uncertainties relating to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern"; and
- Because of their importance, the reporting of such material uncertainties should continue to be required to be an emphasis of matter in the auditor's report.

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See also our response to question 10 in relation to distinguishing between opinions and conclusions.

9. ***What are your views on the value and impediments of including additional information in the auditor's report about the auditor's judgments and processes to support the auditor's statement that no material uncertainties have been identified?***

   As discussed in our response to question 8 the FRC believes that the most pressing concern is to improve the content of accounting standards with respect to going concern generally and in particular to establish a common understanding of the meaning of the expression "material uncertainties relating to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern".

10. ***What are your views on the value and impediments of the suggested auditor statement in relation to other information?***

   The FRC sees benefit in the auditor expressing a conclusion with respect to its reading of the "other information". However, the suggested auditor statement on this subject in the illustrative report seems primarily intended to educate the reader about the audit process and provides little entity specific information.

   The FRC is of the view that a conclusion regarding other information should be included as part of the Opinions and conclusions section of the auditor's report. The conclusion might be expressed along the following lines:

   "*We have read the entire annual report. We confirm that we did not identify any information within it that is materially inconsistent with the audited financial statements or any other matter that is materially incorrectly stated or presented.*"

   This is based on the auditor's responsibilities under extant ISA 720. In our attached illustrative auditor's report we have further developed this to address the specific matters the auditor addresses under the ECS model.

   Distinguishing Opinions and Conclusions from Commentary
   In our outreach, we found that there is broad support for the proposal to include in the auditor's report conclusions on the going concern status of the entity and about the Other Information, that are respectively subsidiary or ancillary to the audit opinion and arise from the audit work done to meet the scope of the audit set out in the ISAs, as well as for the concept of 'auditor commentary'. There is, however, some concern that the conclusions on going concern and Other Information may be seen as standalone opinions on these matters and that auditor commentary may be interpreted as piecemeal opinions.

   The suggestion was that the risk of such misinterpretation may be lessened if these conclusions were to be placed immediately following the opinion (and basis for

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opinion) paragraphs. This would, in effect, create a section of the report that includes the opinion on the financial statements and certain subsidiary and ancillary conclusions arising from the audit work. Compared with the illustrative improved auditor's report in the ITC, this would involve bringing the conclusion on Other Information earlier in the report.

It was suggested that this would also establish a clearer separation between the opinion and conclusions on the one hand and the auditor commentary section on the other (the going concern and Other Information conclusions sandwich the auditor commentary, in the illustrative report in the ITC) and therefore signal more clearly to a reader that the auditor commentary is not intended to be in the nature of standalone opinions or conclusions.

Clarifications and Transparency

11. ***Do you believe the enhanced descriptions of the responsibilities of management, TCWG, and the auditor in the illustrative auditor's report are helpful to users' understanding of the nature and scope of an audit? Why or why not? Do you have suggestions for other improvements to the description of the auditor's responsibilities?***

In response to a perceived expectation gap, the FRC has for many years supported the value of describing the relative responsibilities of the auditor and of those charged with governance in the auditor's report. A significant innovation of the UK auditing standards that were written some twenty years ago was the inclusion of such descriptions.

However, the FRC has come to the view that, since then, the respective responsibilities are now much better understood by market participants and that there is not such an imperative to include these descriptions of responsibilities directly in the auditor's report.

Further, our outreach activities on the auditor's report carried out three or four years ago led us to the conclusion that investors and other stakeholders do not consider it necessary to repeat these statements of responsibility in every auditor's report. This conclusion led the FRC to revise ISA (UK and Ireland) 700 at that time so that auditor's reports would contain only such brief descriptions of the respective responsibilities of auditors and those charged with governance that are required to satisfy the requirements of UK law.

In the UK it is accepted practice for directors to include in an annual report a "statement of management's responsibilities". It is therefore unnecessary for the auditor's report to repeat such information. With respect to the auditor's responsibilities the FRC describes these on a "Scope of Audit" page on its web-site and encourages auditors to cross refer to this.

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Many market participants in the UK acknowledge that the preceding steps have had a positive effect in cutting some of the clutter (boiler plate) from UK auditor's reports.

In our outreach, it was clear that there continues to be very strong support from UK stakeholders for the removal of as much standardised language as possible from the auditor's report. This comment was most frequently made in the context of the improved standardised language regarding the description of the scope of an audit and the responsibilities of directors and auditors. UK stakeholders to whom we spoke (whether corporate, investor or auditor), were virtually unanimous in believing that such text should ideally be removed from the auditor's report and included in the Scope of Audit document, which is retained on our website and to which the UK and Ireland auditor is permitted to cross refer in the auditor's report, or at least be included at the very end of the auditor's report as part of a third 'reference section'.

When the Clarity ISAs were introduced in the UK and Ireland, we responded to similar feedback from stakeholders by reducing the standardised language in the auditor's report where possible. This included omitting from the required language of the ISA (UK and Ireland) 700 auditor's report text equivalent to that in the last sentence of the basis of opinion paragraph in the illustrative improved auditor's report in the ITC and permitting a cross reference to a Scope of audit document held on our website. There was support for continuing to maintain these features of the auditor's report.

There was nonetheless strong support for the improved language of the description of the auditor's responsibilities included in the ITC - the concerns were a question of placement. There is a strong body of support in the UK for increasing the relevance of both corporate reports and auditor's reports by not allowing standardised or 'boilerplate' language to 'clutter' such communications. Where such language is important context, it should be made accessible to the reader as a reference resource (we have illustrated this in Appendix 4).

12. ***What are your views on the value and impediments of disclosing the name of the engagement partner?***

Disclosing the name of the engagement partner has been required practice in the UK for a few years. Disclosing his or her name is widely believed to improve the engagement partner's sense of accountability and thereby to indirectly improve audit quality. We are not aware of any impediments to disclosing the name of the engagement partner other than the need for any relevant requirements to permit derogation in circumstances where there is a serious risk that the engagement partner may be subject to violence or intimidation. (There has been a very real risk of this on audits of entities that undertake controversial activities such as researching the effect of new pharmaceuticals on animals.)

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13. What are your views on the value and impediments of the suggested disclosure regarding the involvement of other auditors? Do you believe that such a disclosure should be included in all relevant circumstances, or left to the auditor's judgment as part of Auditor Commentary?

We are aware that investors often express interest in understanding the extent to which other auditors have been involved in the audit. However, we believe that this disclosure should form a part of fuller disclosures by the auditor regarding the auditor's engagement specific decisions about the application of materiality, the identification of risks they consider significant in relation to their audit and the consequential scoping of their audit. The alternative illustrative auditor's report in Appendix 2 illustrates such disclosures. In our outreach discussions, there was strong support from investors for auditors to include such disclosures in the auditor's report in an entity specific manner.

14. What are your views on explicitly allowing the standardized material describing the auditor's responsibilities to be relocated to a website of the appropriate authority, or to an appendix to the auditor's report.

We strongly support allowing standard material to be relocated from the auditor's report to a web-page. By removing language that is the same for all audits, and not therefore decision useful, auditor's reports are made more relevant and readable.

UK and Ireland auditing standards provide an option whereby the auditor's report can cross refer to a description of the Scope of the Audit of Financial Statements that is maintained on the FRC's web-site. Typically a hot link is provided in the auditor's reports of listed companies.

Our objective in providing this option was to endeavour to remove standard language from auditor's reports. Approximately 50% of the larger audit firms choose this option and our outreach confirms that this change has been welcomed by investors and other users. There is regular traffic to the relevant page on our web-site and this suggests that readers of auditor's reports regularly use the hot links to read the FRC's description of the scope of an audit. The outreach we have carried out in developing this response has indicated support for FRC removing as much standard language as possible from the auditor's report and including it on an appropriate web-page.

Form and Structure

15. What are your views on whether the IAASB's suggested structure of the illustrative report, including placement of the auditor's opinion and the Auditor Commentary section towards the beginning of the report, gives appropriate emphasis to matters of most importance to users?

In the outreach activities that we have undertaken strong support has been expressed for placing the auditor's opinion at the beginning of the report. As

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explained in our covering letter we believe that all of the opinions and conclusions expressed by the auditor should be included together at the beginning of the auditor's report. The opinions and conclusions section should then be followed by separate sections devoted to auditor commentary and a standardised description of the scope of an audit (with the latter ideally cross referred to a publicly available document).

16. What are your views regarding the need for global consistency in auditor's reports when ISAs, or national auditing standards that incorporate or are otherwise based on ISAs, are used.

The FRC strongly supports global consistency in the application of the operational ISAs. However, subject to the inclusion in the auditor's report of certain defined minimum elements, we do not believe that global consistency in the form and structure of the auditor's report is either necessary or desirable, primarily because in some jurisdictions the auditor's responsibilities go beyond those implicit in the ISA audit. In those circumstances, in order to be relevant to investors, the auditor's report needs to be responsive to the unique scope and reporting requirements of the jurisdiction.

Our outreach activities, in connection with developing this response, have revealed strong support amongst investors in UK companies (as well as many other stakeholders) for the adaptive changes we have made to the IAASB's illustrative improved auditor's report included in the ITC. We consider that these changes are necessary in order to be responsive to the scope and reporting requirements of an auditor in our jurisdiction.

In the United Kingdom, for example:

- The auditor is not permitted to limit its opinion on whether the financial statements give a true and fair view (i.e. is not able to state that the financial statements give a "true and fair view in accordance with IFRS");
- There are a number of reporting requirements with respect to going concern and directors remuneration disclosures arising from the Listing Rules and investors want these integrated with any reporting requirements that arise from a pure ISA audit;
- The ECS model seeks to close the information gap primarily through enhanced disclosures by those charged with governance, informed by enhanced auditor communications to them from the auditor, rather than through the provision of direct auditor commentary (except where directors do not meet their enhanced reporting responsibilities). Therefore, investors in our jurisdiction want the auditor to be able to cross-refer to appropriate disclosures made by the directors about the entity and its financial statements rather than directly disclosing the same information again in the auditor's report; and
- Public Sector auditors also have to express their opinion on regularity, which is fundamentally different from their opinion on the financial statements, and that opinion is seen to be at least as important as the opinion on the financial

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statements and to require at least as much prominence in the auditor's report.

We are aware of other similar national scope and reporting differences, such as those arising from the French "Justification of Assessments" model.

Insisting on a move away from the current ISA 700 model (paragraph 43 of which includes important discretion to accommodate national or regional legal and regulatory differences in auditor scope and reporting requirements) to one which requires global rigidity in the form and structure of auditor's reports (as has been suggested by some) may give rise to irreconcilable conflicts between the requirements of the reporting ISAs and the requirements of national laws and regulations that cannot submit to the sovereignty of the ISAs. This would in our view unnecessarily prevent a jurisdiction whose auditing standards comply wholly with the operational standards from asserting compliance with the ISAs unless it were to conform its national law and regulations to the specific scope and reporting requirements of the ISAs in all respects.

At present, the FRC has adopted ISA 700 as issued by the IAASB, exercising the discretion permitted by paragraph 43 to accommodate scope and reporting requirements that emanate from laws and regulations in the UK and Ireland such as those referred to above. We, therefore, very much hope that equivalent discretion will be retained and built upon in the revised ISAs that emerge in the light of responses to the ITC. Such discretion should, among other things, enable other approaches to closing the information gap, such as our governance driven ECS model, so long as it can be demonstrated that there are adequate safeguards to ensure that the equivalent information would either be adequately disclosed by the directors or that the auditor would be required to make good any such disclosures that it considered inadequate.

17. ***What are your views as to whether the IAASB should mandate the ordering of items in a manner similar to that shown in the illustrative report, unless law or regulation require otherwise? Would this provide sufficient flexibility to accommodate national reporting requirements or practice?***

We have undertaken considerable out-reach activities with UK and Ireland stakeholders with respect to the IAASB's ITC focusing in particular on how these proposals can be reconciled with our ECS model and in doing so we have explored the implications for the illustrative improved auditor's report in the ITC. Whilst we have found much support for the aims of the IAASB's initiative, a significant number of those whom we have consulted have expressed concerns about aspects of the structure of the proposed report, as well as making suggestions for improvement, which are described in more detail in our letter but included the following:

- the audit opinion and other conclusions and opinions (including those relating to going concern, other information and those required by other legal and regulatory requirements) being brought together in a section before the auditor

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commentary to more clearly distinguish them from each other – integrating reporting on a particular subject matter, whether required under the ISAs or by law or regulation;

- cutting clutter from the auditor's report by moving standardised language regarding the description of the scope of an audit and the responsibilities of directors and auditors to a separate section at the end of the auditor's report or, more preferably, permitting it to be removed from the auditor's report and replaced by a cross reference to where it is described on the standard-setter's web-site;
- retaining emphasis of matters paragraphs outside the commentary section and requiring them to be included in the section of the auditor's report dealing with the auditor's opinions and conclusions (see above);
- removing the auditor's conclusion on the appropriateness of the going concern assumption and permitting the conclusion of material uncertainties to be integrated with other statutory; and
- positioning in the auditor's report other reports the auditor is required to provide by law or regulation, on matters outside the scope of the ISA audit (such as, in the public sector, an opinion on regularity), appropriately relative to their significance to users.

Consolidating the comments that we have heard would lead to an auditor's report consisting of the three principal elements depicted in the diagram on page 9 of our covering letter.

18. In your view, are the IAASB's suggested improvements appropriate for entities of all sizes and in both the public and private sectors? What considerations specific to audits of small and medium-sized entities (SMEs) and public sector entities should the IAASB further take into account in approaching its standard setting proposals?

We address this question in our response to question 7.

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Appendix 2 - Illustrative IAASB improved auditor’s report as modified to reflect UK laws and regulations and ECS

INDEPENDENT AUDITOR’S REPORT TO THE MEMBERS OF ABC PLC

I. Opinions and conclusions arising from our audit

Opinion on the financial statements

In our opinion:
- the financial statements give a true and fair view of the state of the Group’s and of the Parent Company’s affairs as at 31 December 20X1 and of the Group’s profit for the year then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union; and
- the financial statements 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.

The financial statements comprise the accompanying Group and Parent Company statements of financial position, the Group statement of comprehensive income, the Group and Parent Company statements of changes in equity and statements of cash flows, and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

Emphasis of matter – uncertain outcome of a lawsuit

In forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosures made in note [x] to the financial statements concerning the uncertain outcome of a lawsuit, alleging infringement of certain patent rights and claiming royalties and punitive damages where a wholly owned subsidiary company is the defendant. The subsidiary has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

Basis for Opinion on the financial statements

We have audited the financial statements in accordance with applicable law and International Standards on Auditing (ISAs) (UK and Ireland). Our responsibilities under those standards are further described in the *Auditor’s Responsibility* section of our report. In performing our audit, as required by those standards, we complied with the Financial Reporting Council’s Ethical Standards for Auditors including those requiring us to be independent and objective.

Opinions on matters prescribed by the Companies Act 2006

In our opinion:
- the information given in the Directors’ Report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the part of the Directors’ Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006.

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Appendix 2 - Illustrative IAASB improved auditor's report as modified to reflect UK laws and regulations and ECS

Conclusion relating to "Going Concern"

As required by the Listing Rules we have reviewed the directors' statement on page xx that the business is a going concern. We have nothing to report in relation to that statement arising either from that review or from our audit of the financial statements[3]. In particular, we have not identified material uncertainties related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern which we believe would need to be disclosed in accordance with IFRSs as adopted by the European Union.

Conclusion arising from our reading of the Annual Report

As part of our audit, we have read the entire annual report and considered it in light of the knowledge of the Group we acquired in the course of performing the audit. We confirm that we did not identify any information within it that is materially inconsistent with the audited financial statements or with that knowledge, or that is otherwise materially incorrectly stated or presented or misleading. In particular: we have not identified any inconsistency with our knowledge regarding the directors' statement that the annual report is fair, balanced and understandable; and we confirm that the annual report appropriately discloses those matters that we communicated to the Audit Committee and consider should have been disclosed.

Other matters on which we are required to report by exception

As more fully explained in the description of the scope of an audit maintained on the FRC's website at www.frc.org.uk/apb/scope/private.cfm, we are required to report by exception regarding:

- whether we have received all the information and explanations we require for our audit;
- the adequacy of accounting records and whether the financial statements agree with the accounting records;
- the adequacy of certain directors' remuneration disclosures; and
- our review of certain aspects of the Corporate Governance Statement.

We have nothing to report arising from these responsibilities.

II. Auditor Commentary

Without modifying our opinion on the financial statements, we highlight the following matters that are, in our judgment, likely to be most important to users' understanding of the audited financial statements or our audit. Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures.

Significant matters arising from our audit
On page xx of the Annual Report the directors state that they consider the annual report and accounts taken as a whole to be fair, balanced and understandable and page yy describes the significant issues that the Audit Committee considered in relation to the financial statements and how these issues were addressed. We communicated to the Audit Committee the information arising from our audit that we believed would be relevant to the Board and the Audit Committee in fulfilling these reporting responsibilities. The disclosures about the work of the Audit Committee include the issues which gave rise to the closest

[3] Our responsibilities in relation to going concern in performing the audit are explained in the description of the scope of an audit at www.frc.org.uk/apb/scope/private.cfm.

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scrutiny, in our communications with the Audit Committee, of the various judgments made by management in preparing the financial statements.

Our assessment of risks significant to our audit
We identified the following risks that we believed to be significant to our audit and that, therefore, required special audit consideration:

- The timing of revenue recognition, including that relating to long-term contracts in the Services' business;
- Internal control failures in the Far Eastern businesses, including the risk of fraud and illegal payments;
- Impairment of fixed assets and goodwill in the European businesses; and
- The Group's exposure to unpredictable tax and legal risks in emerging markets.

Our assessment of materiality
We determined planning materiality[4] for the Group to be £600 million (20X0 – £550 million), which is below 5% (20X0 – 5%) of normalised[1] pre-tax profit, and below 1% (20X0 – 1%) of equity. On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgment is that overall performance materiality[1] for the Group should be 75% (20X0 – 75%) of planning materiality, namely £450 million (20X0 – £413 million). Our objective in adopting this approach was to ensure that total detected and undetected audit differences in all accounts would not exceed our planning materiality level.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £30 million (27.5 million), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

Companies within the Group in emerging markets are defendants in certain legal actions alleging damage to the environment arising from the company's activities. There is considerable uncertainty over both the merits of such claims and their ultimate outcome. Given that, in this case, the reasonable range of potential outcomes exceeded our quantitative measure of planning materiality, we evaluated materiality in relation to this item qualitatively. Our evaluation was primarily based on our assessment of the extent to which a description of the uncertainties and of the range of potential outcomes, in the relevant notes to the financial statements, would be relevant to the economic decisions of a shareholder taken on the basis of the financial statements as a whole.

The scope of our audit
Our Group audit scope focused on the audit work at 12 locations. Five of these were subject to a full audit, whilst the remaining seven were subject to a partial audit where the extent of our testing was based on our assessment of the audit risk and materiality of the Group's business operations at those locations. These 12 locations represent the principal business units within the Group's three reportable segments and account for 72% (68%) of the Group's total assets and 63% (66%) of the Group's profit before tax. They were also selected to provide an appropriate basis for undertaking audit work to address the significant audit risks identified above. In addition, we performed statutory audits at a further 60 (20X0 – 58) locations, which represented a further 25% (20X0 – 27%) of the Group's total assets and 32% (20X0 – 29%) of the Group's profit before tax. Our audit work at the 12 locations and our statutory audits were executed at levels of materiality applicable to each individual entity, which are much lower than Group materiality.

[4] The terms planning materiality, normalised pre-tax profit and performance materiality are explained in the description of the scope of an audit at www.frc.org.uk/apb/scope/private.cfm

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Appendix 2 - Illustrative IAASB improved auditor's report as modified to reflect UK laws and regulations and ECS

The Group audit team continued to follow a programme of planned visits that has been designed to ensure that the Senior Statutory Auditor visits each of the locations where the Group audit scope was focused at least once every two years and the most significant of them at least once a year.

The Group has interests in a number of material joint ventures some of which are not operated by the Group and of which we are not the auditor. In all of these cases, the Group has audit rights that provided us with the necessary access in order to perform specific procedures. Approximately 18% (20X0 – 15%) of the Group's total assets and 16% (20X0 – 17%) of the Group's profit before tax fell into this category.

III. Respective Responsibilities of Directors and Auditor

Responsibility of Directors for the Annual Report and Financial Statements
As explained more fully in the Directors' Responsibilities Statement set out on page xx, the directors are responsible for ensuring that the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for users to assess the Group's performance, business model and strategy. With respect to the financial statements, the directors are responsible for the adequacy of the accounting records, the preparation of the financial statements from those records and for being satisfied that the financial statements give a true and fair view.

Auditor's Responsibility
Our responsibility is to audit and express an opinion on the financial statements, and to provide other reports and communications arising from our audit, in accordance with applicable law, regulations and International Standards on Auditing (UK and Ireland). As part of an audit performed in accordance with the International Standards on Auditing (UK and Ireland), we exercise professional judgment and maintain professional scepticism throughout the planning and performing of the audit.

A fuller description of the scope of an audit of financial statements performed in accordance with ISAs (UK and Ireland) and UK laws and regulations applicable to the Group is provided on the FRC's website at www.frc.org.uk/apb/scope/private.cfm.

[Signature]

[Name] (Senior Statutory Auditor for and on behalf of LMN LLP, Statutory Auditor)

[Address]

[Date]

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Appendix 3 - Illustrative IAASB improved auditor's report as modified to reflect UK laws and regulations and ECS annotated to explain rationale for changes from the illustrated report in the ITC

INDEPENDENT AUDITOR'S REPORT TO THE ~~Shareholders~~ MEMBERS OF ABC ~~Company [or Other Appropriate Addressee]~~PLC

I. Opinions and conclusions arising from our audit

~~Report~~Opinion on the financial statements

~~Opinion~~

In our opinion~~,~~:

- the ~~accompanying~~financial statements ~~present fairly, in all material respects, (or~~ give a true and fair view of~~)~~ the state of the ~~financial position~~ Group's and of ~~ABC Company (~~the ~~Company)~~Parent Company's affairs as at 31 December ~~31~~ 20X1~~,~~ and ~~(~~of~~) its financial performance and its cash flows~~ the Group's profit for the year then ended;
- the financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs)~~.~~ as adopted by the European Union; and
- the financial statements 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.

The financial statements comprise the accompanying Group and Parent Company statements of financial position ~~as at December 31, 20X1~~, the Group statement of comprehensive income, ~~statement~~ the Group and Parent Company statements of changes in equity and statements of cash flows ~~for the year then ended~~, and the related notes ~~to the financial statements, including a summary of significant accounting policies and other explanatory information~~. The financial reporting framework that has been applied in their preparation is applicable law and IFRSs as adopted by the European Union.

Emphasis of matter – uncertain outcome of a lawsuit

In forming our opinion on the financial statements, which is not modified, we have considered the adequacy of the disclosures made in note [x] to the financial statements concerning the uncertain outcome of a lawsuit, alleging infringement of certain patent rights and claiming royalties and punitive damages where a wholly owned subsidiary company is the defendant. The subsidiary has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

Comment [MG1]: Reflects UK Company Law requirements – CA 2006 – Section 495(1)

Comment [MG2]: Reflects suggested 3 section structure of the audit report

Comment [MG3]: In the suggested 3 section structure, the distinction between a report and an opinion is no longer relevant at this level since this section only includes opinions and conclusions and each is appropriately titled.

Comment [MG4]: The word 'accompanying' has been moved down – see Comment MG6 in order to avoid repeating it three times given the three-part opinion on the financial statements required in these bullets – see Comment MG5.

Comment [MG5]: Changes in text reflect the fact that UK company law requires a three-part opinion (CA 2006 section 495(3)).

Comment [MG6]: The word 'accompanying' has been moved down to here - see Comment MG4.

Comment [MG7]: These changes are necessary to appropriately describe the actual financial statements that are subject to the opinion in the UK.

Comment [MG8]: The applicable framework is required to be disclosed in the UK – see CA 2006 – section 495(2)(a).

Comment [MG9]: This EOM paragraph has been inserted to illustrate our suggestion that EOMs should be retained as distinct from Auditor Commentary and should be placed in our suggested Section I of the report (Opinions and Conclusions).

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Basis for Opinion on the financial statements

We have audited the ~~accompanying~~ financial statements in accordance with applicable law and International Standards on Auditing (ISAs) (UK and Ireland). Our responsibilities under those standards are further described in the *Auditor's Responsibility* section of our report. In performing our audit, as required by those standards, we complied with the Financial Reporting Council's Ethical Standards for Auditors including those requiring us to be ~~relevant ethical requirements applicablefinancial statement audits, including~~ independent and objective ~~ce requirements~~. ~~We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.~~

Opinions on matters prescribed by the Companies Act 2006

In our opinion:

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

Conclusion relating to "Going Concern"

~~*Use of Going Concern Assumption*~~

~~As part of our audit of the financial statements, we have concluded that management's use of the the going concern assumption in the preparation of the financial statements is appropriate.~~

~~*Material Uncertainties Related to Events of Conditions that May Cast Significant Doubt on the Company's Ability to Continue as a going concern*~~

As required by the Listing Rules we have reviewed the directors' statement on page xx that the business is a going concern. We have nothing to report in relation to that statement arising either from that review or from our audit of the financial statements[1]. ~~Based on the work we have performed~~In particular, we have not identified material uncertainties related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern ~~that~~which we believe would need to be disclosed in accordance with IFRSs as adopted by the European Union. ~~Because not all future events or conditions can be predicted, this statement is not a guarantee as to the Company's ability to continue as a going concern.~~

~~The responsibilities of management with respect to going concern are described in a separate section of our report.~~

[1] Our responsibilities in relation to going concern in performing the audit are explained in the description of the scope of an audit at www.frc.org.uk/apb/scope/private.cfm.

Comment [MG10]: Added for clarity.

Comment [MG11]: Not needed as the 'financial statements' are now defined as comprising various accompanying statements (see Comment MG6).

Comment [MG12]: This is needed because Company law specifies auditing requirements that go beyond the ISAs – see eg CA 2006 Sections 495 to 506.

Comment [MG13]: References UK & Ireland Standards which are based on the ISAs.

Comment [MG14]: Textual changes reflect UK preference to refer not only to independence but also objectivity, as we consider this more fundamental than independence, and to state that compliance with the ethical requirements is required by the auditing standards in the UK.

Comment [MG15]: As discussed in our response, we believe this language is self-evident standardised language that should not be included in the audit report. The requirement to obtain such evidence is referred to in the Scope of Audit document.

Comment [MG16]: These are specific matters on which the auditor is required to provide an opinion under UK law – see CA 2006 – Sections 496 and 497.

Comment [MG17]: Title modified to highlight that this is an audit conclusion not a separate opinion.

Comment [MG18]: As explained in our letter, we believe this conclusion should not be included in the auditor's report.

Comment [MG19]: As explained in our letter, this reflects the requirement of the UK Listing Rules for the auditor to review the directors' going concern statement made pursuant to the Listing Rules.

Comment [MG20]: The use of 'which' avoids the double use of 'that' but is largely a matter of style in English.

Comment [MG21]: Addresses the actual applicable accounting framework.

Comment [MG22]: As set out in our letter, we consider this to be standardised language that should be included in the Scope document if retained – see Appendix 4.

Comment [MG23]: Deleted as this is standardised language that creates clutter.

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~~Other Information~~Conclusion arising from our reading of the Annual Report

As part of our audit, we have read ~~[clearly identify the specific other information read eg the Chairman's Statement, the Business Review, etc]~~ the entire annual report and considered it in light of the knowledge of the Group we acquired in the course of performing the audit. We confirm that we did not identify any information within ~~contained in [specify the document containing the other information, eg the annual report]~~ it that is~~, for the purpose of identifying whether there are~~ materially inconsistent~~cies~~ with the audited financial statements or with that knowledge, or that is otherwise materially incorrectly stated or presented or misleading. ~~Based upon reading it, we have not identified material inconsistencies between this information and the audited financial statements.~~ In particular: we have not identified any inconsistency with our knowledge regarding the directors' statement that the annual report is fair, balanced and understandable; and we confirm that the annual report appropriately discloses those matters that we communicated to the Audit Committee and consider should have been disclosed. ~~However, we have not audited this information and accordingly do not express an opinion on it.~~

Other matters on which we are required to report by exception

As more fully explained in the description of the scope of an audit maintained on the FRC's website at www.frc.org.uk/apb/scope/private.cfm, we are required to report by exception regarding:

- whether we have received all the information and explanations we require for our audit;
- the adequacy of accounting records and whether the financial statements agree with the accounting records;
- the adequacy of certain directors' remuneration disclosures; and
- our review of certain aspects of the Corporate Governance Statement.

We have nothing to report arising from these responsibilities.

~~I.~~II. Auditor Commentary

Without modifying our opinion on the financial statements, we highlight the following matters that are, in our judgment, likely to be most important to users' understanding of the audited financial statements or our audit. Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures.

Significant matters arising from our audit

On page xx of the Annual Report the directors state that they consider the annual report and accounts taken as a whole to be fair, balanced and understandable and page yy describes the significant issues that the Audit Committee considered in relation to the financial statements and how these issues were addressed. We communicated to the Audit Committee the information arising from our audit that we believed would be relevant to the Board and the Audit Committee in fulfilling these reporting responsibilities. The disclosures about the work of the Audit Committee include the issues which gave rise to the closest scrutiny, in our communications with the Audit Committee, of the various judgments made by management in preparing the financial statements.

Comment [MG24]: This section on Other Information has as discussed in our report been moved up from where it was placed (after auditor commentary) in the ITC (see Comment MG 32), so that it is placed in a separate Section containing all the Opinions and conclusions. The text has been modified to:
- In the title, to identify this as a conclusion and to refer to the Annual Report rather than to the likely to be less well understood term 'Other information'
- Identify the Other Information as the 'entire annual report'
- Add the auditor's responsibility under ECS in the UK & Ireland to consider the Other Information in light of the auditor's knowledge gained in the course of the audit
- To avoid repeating the responsibility to identify material inconsistencies by only addressing this in the auditor's conclusion
- To add the two specific conclusions required by ECS in relation to fair balanced and understandable and the matters communicated to the Audit Committee

Comment [MG25]: Deleted as this is standardised language that creates clutter.

Comment [MG26]: These conclusions are required by the ISAs (UK & Ireland) in relation to matters that the auditor is required to report by exception in accordance with company law and the UK Listing Rules – see ISA (UK&I) 700 paragraph 22, CA 2006 Section 498 and LR 9.8.10R.

Comment [MG27]: Added for clarity

Comment [MG28]: This reflects the approach required by ECS as explained in our letter

Aldwych House, 71-91 Aldwych, London WC2B 4HN Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2399 www.frc.org.uk

~~*Outstanding Litigation*~~
~~The Company is exposed to various claims and contingencies in the normal course of business. We draw attention to Note 9, which describes the uncertainty related to an environmental claim regarding a business that was sold by the Company in 20X0.~~

~~*Goodwill*~~
~~As disclosed in Note 3, in 20X0, the Company acquired a significant operation in [location]. Goodwill attributable to this acquisition is XXX, which is material to the financial statements as a whole. The annual impairment test, as described in the Company's summary of significant accounting policies, is complex and highly judgmental. Due to the current economic conditions as discussed on page X Management Commentary, there is significant uncertainty embedded in the future cash flow projections used in the impairment calculation. The Company performed this testing as at [date]. No impairment was recognised because the recoverable amount of the unit to which the goodwill was allocated marginally exceeded its carrying value at that date. The Company has disclosed that a decline of Y% in the fair value of this unit would, all other things being equal, give rise to an impairment of the goodwill in the future and such an impairment would have a material negative effect on the Company's statement of financial position and statement of comprehensive income, but would not impact its cash flow from operations.~~

~~*Valuation of Financial Instruments*~~
~~The Company's disclosure with respect to its structured financial instruments is included in Note 5. Due to the significant measurement uncertainty associated with these instruments, we determined that there was a high risk of material misstatement of the financial statements related to the valuation of them. As part of our response to this risk, our firm's valuation specialists developed an independent range for purposes of evaluating the reasonableness of management's fair value estimate, which was determined through its use of a model. Management's recorded amount fell within our range.~~

~~*Audit Strategy Relating to the Recording of Revenue, Accounts Receivable and Cash Receipts*~~
~~During the year, the Company implemented a new system to record revenue, accounts receivable and cash receipts, which involved the introduction of new accounting software. The new system centralises processes and related internal control for five of the Company's seven operating segments. These processes and controls are significant to our audit of the financial statements because they affect a number of material financial statement accounts. We discussed the effect of the new system implementation on our audit strategy with those charged with governance, including our consideration of the work that had been performed on the new system by the Company's internal audit function. Our audit strategy included supporting our understanding of the design of the new system through discussion with relevant personnel; testing the effectiveness of key controls; and testing the transfer of balances to the new accounting ledgers.~~

Comment [MG29]: These matters have been deleted because, as explained in our letter, normally under ECS they would be addressed in the Section of the annual report dealing with the work of the audit committee. However, if the auditors considered that the directors had not fulfilled their duty to report such matters, the auditor would be required to address them here in the auditor's report.

Our assessment of risks significant to our audit
We identified the following risks that we believed to be significant to our audit and that, therefore, required special audit consideration:

- The timing of revenue recognition, including that relating to long-term contracts in the Services' business;
- Internal control failures in the Far Eastern businesses, including the risk of fraud and illegal payments;
- Impairment of fixed assets and goodwill in the European businesses; and
- The Group's exposure to unpredictable tax and legal risks in emerging markets.

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Our assessment of materiality
We determined planning materiality[2] for the Group to be £600 million (20X0 – £550 million), which is below 5% (20X0 – 5%) of normalised[1] pre-tax profit, and below 1% (20X0 – 1%) of equity. On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgment is that overall performance materiality[1] for the Group should be 75% (20X0 – 75%) of planning materiality, namely £450 million (20X0 – £413 million). Our objective in adopting this approach was to ensure that total detected and undetected audit differences in all accounts would not exceed our planning materiality level.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £30 million (27.5 million), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

Companies within the Group in emerging markets are defendants in certain legal actions alleging damage to the environment arising from the company's activities. There is considerable uncertainty over both the merits of such claims and their ultimate outcome. Given that, in this case, the reasonable range of potential outcomes exceeded our quantitative measure of planning materiality, we evaluated materiality in relation to this item qualitatively. Our evaluation was primarily based on our assessment of the extent to which a description of the uncertainties and of the range of potential outcomes, in the relevant notes to the financial statements, would be relevant to the economic decisions of a shareholder taken on the basis of the financial statements as a whole.

The scope of our audit
Our Group audit scope focused on the audit work at 12 locations. Five of these were subject to a full audit, whilst the remaining seven were subject to a partial audit where the extent of our testing was based on our assessment of the audit risk and materiality of the Group's business operations at those locations. These 12 locations represent the principal business units within the Group's three reportable segments and account for 72% (68%) of the Group's total assets and 63% (66%) of the Group's profit before tax. They were also selected to provide an appropriate basis for undertaking audit work to address the significant audit risks identified above. In addition, we performed statutory audits at a further 60 (20X0 – 58) locations, which represented a further 25% (20X0 – 27%) of the Group's total assets and 32% (20X0 – 29%) of the Group's profit before tax. Our audit work at the 12 locations and our statutory audits were executed at levels of materiality applicable to each individual entity, which are much lower than Group materiality.

The Group audit team continued to follow a programme of planned visits that has been designed to ensure that the Senior Statutory Auditor visits each of the locations where the Group audit scope was focused at least once every two years and the most significant of them at least once a year.

The Group has interests in a number of material joint ventures some of which are not operated by the Group and of which we are not the auditor. In all of these cases, the Group has audit rights that provided us with the necessary access in order to perform specific procedures. Approximately 18% (20X0 – 15%) of the Group's total assets and 16% (20X0 – 17%) of the Group's profit before tax fell into this category.

Comment [MG30]: As explained in our letter, we have added this text to illustrate auditor commentary that provides insights into the key judgments about the audit.

[2] The terms planning materiality, normalised pre-tax profit and performance materiality are explained in the description of the scope of an audit at www.frc.org.uk/apb/scope/private.cfm

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~~*Involvement of Other Auditors*~~

~~At our request, other auditors performed procedures on the financial information of certain subsidiaries to obtain audit evidence in support of our audit opinion. The work of audit firms with which we are affiliated constituted approximately *[percentage of audit measured by, for example, audit hours]* of our audit and the work of other non-affiliated audit firms constituted approximately *[percentage of audit measured by, for example, audit hours]* of our audit. Our responsibilities for the audit are explained in the Auditor's Responsibility section of our report.~~

Comment [MG31]: Although we have deleted this text, it could (as explained in our letter) be provided as part of the illustrative auditor commentary that provides insights into the key judgments about the audit.

~~**Other Information**~~

~~As part of our audit, we have read [*clearly identify the specific other information read eg the Chairman's Statement, the Business Review, etc]* contained in [specify the document containing the other information, eg the annual report], for the purpose of identifying whether there are material inconsistencies with the audited financial statements. Based upon reading it, we have not identified material inconsistencies between this information and the audited financial statements. However, we have not audited this information and accordingly do not express an opinion on it.~~

Comment [MG32]: As discussed in our letter, this has been moved up into the Section of the report that includes all the auditor's opinions and conclusions – see Comment MG24.

III. Respective Responsibilities of Directors~~Management, [Appropriate Title for Those Charged with Governance]~~ and ~~the~~Auditor

Comment [MG33]: In the UK, the Directors are responsible both for the preparation and oversight of the financial statements. Therefore it would be appropriate only to refer to the responsibilities of the Directors in the title of this section in a UK auditor's report.

Responsibility of~~Management and [Those charged with Governance]~~ Directors for the Annual Report and Financial Statements

Comment [MG34]: The auditor reports under UK law and regulation not only in relation to the financial statements but also in relation to the annual report.

As explained more fully in the Directors' Responsibilities Statement set out on page xx, the directors are responsible for ensuring that the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for users to assess the Group's performance, business model and strategy. With respect to the financial statements, the directors are responsible for the adequacy of the accounting records, the preparation of the financial statements from those records and for being satisfied that the financial statements give a true and fair view.~~Management is responsible for the preparation and fair presentation of these financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. [Those charged with governance] are responsible for overseeing the Company's financial reporting process.~~

Comment [MG35]: In the UK, the directors provide a responsibility statement that is much longer and deals more fully with their responsibilities than the proposed text in the auditor's report in the ITC. UK company law makes no explicit references to internal control per se. It does make reference to the need for adequate accounting records and this reference is therefore equivalent to the proposed ISA reference to internal control.

~~Management's Responsibilities Relating to Going Concern~~

~~Under IFRSs, management is responsible for making an assessment of the Company's ability to continue as a going concern when preparing the financial statements. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. Under IFRSs, the Company's financial statements are prepared on a going concern basis, unless management either intends to liquidate the Company or to cease trading, or has no realistic alternative but to do so.~~

~~IFRSs also require that, when management is aware of material uncertainties related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern, management disclose those uncertainties in the financial statements.~~

Comment [MG36]: This has been deleted from here as it is standardised text that clutters the audit report.

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Auditor's Responsibility

~~The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.~~

~~As part of an audit in accordance with ISAs,~~Our responsibility is to audit and express an opinion on the financial statements, and to provide other reports and communications arising from our audit, in accordance with applicable law, regulations and International Standards on Auditing (UK and Ireland). As part of an audit performed in accordance with the International Standards on Auditing (UK and Ireland), we exercise professional judgment and maintain professional scepticism throughout the planning and performing of the audit. ~~We also:Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.~~

~~Obtain an understanding of internal control relevant to the audit 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 Company's internal control.~~

~~Obtain sufficient appropriate audit evidence regarding the financial information of entities and business activities within the group to express an opinion on the group financial statements. We are responsible for the direction, supervision and performance of the group audit engagement and remain solely responsible for our audit opinion.~~

~~Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.~~

~~Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.~~

~~Communicate with [those charged with governance] regarding, among other matters, the planned scope and timing of the audit, the significant audit findings, and any significant deficiencies in internal control that we identify during our audit. We also communicate with them regarding all relationships and other matters that we believe may reasonably be thought to bear on our independence.~~

A fuller description of the scope of an audit of financial statements performed in accordance with ISAs (UK and Ireland) and UK laws and regulations applicable to the Group is provided on the FRC's website at www.frc.org.uk/apb/scope/private.cfm.

Comment [MG37]: As discussed in our letter, this text is standardised and clutters the audit report. It has been moved to the Scope of Audit document – see cross reference to FRC website below – Comment MG39.

Comment [MG38]: As discussed in our letter, this text is standardised and clutters the audit report. It has been moved to the Scope of Audit document – see cross reference to FRC website below – Comment MG39.

Comment [MG39]: This is a cross reference to a fuller description of the scope of an audit on the FRC's website.

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~~**Report on Other Legal and Regulatory Requirements**~~

~~The engagement partner responsible for the audit resulting in this report is [name].~~

Comment [MG40]: These matters have, where they arise, been integrated into proposed Section 1 of the report (Opinions and conclusions) so that all of the auditor's opinions and conclusions addressing any particular subject matter is kept together.

[Signature~~in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction~~]

[Name] (Senior Statutory Auditor for and on behalf of LMN LLP, Statutory Auditor)

[Address]

[Date]

Aldwych House, 71-91 Aldwych, London WC2B 4HN Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2399 www.frc.org.uk

Appendix 4 – Illustrative Scope of Audit Document consistent with the illustrative auditor's report at Appendix 2

SCOPE OF AN AUDIT OF FINANCIAL STATEMENTS OF UK PRIVATE SECTOR COMPANIES

Requirements of International Standards on Auditing (ISAs) (UK and Ireland)

Overview
An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the entity's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, as part of the audit, the auditor reads [all the financial and non-financial information in the annual report] and considers it in light of the knowledge of the entity the auditor acquired in the course of performing the audit to identify whether there are material inconsistencies with the audited financial statements or with that knowledge or any information is otherwise apparently materially incorrectly stated or presented or misleading.

Overall objectives
In order to provide the report to the company's members required by section 495 of the Companies Act 2006, the auditor plans and performs an audit of the financial statements in accordance with ISAs (UK and Ireland) and the APB's Ethical Standards. As part of an audit in accordance with ISAs (UK and Ireland) and the APB's Ethical Standards, the auditor is required to be independent and objective, to exercise professional judgment and to maintain professional scepticism throughout the planning and performance of the audit.

The overall objectives of the auditor are to:
- (a) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
- (b) to issue an auditor's report that includes the auditor's opinion on the financial statements; and
- (c) to provide other reports and communications, in accordance with applicable law, regulations and the ISAs (UK and Ireland).

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK and Ireland) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Compliance with the ISAs (UK and Ireland)
The auditor is required to comply with all ISAs (UK and Ireland) that are relevant to the audit.

ISAs (UK and Ireland):
- Require the auditor to plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.
- Require the auditor to exercise professional judgment in planning and performing an audit.

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Appendix 4 – Illustrative Scope of Audit Document consistent with the illustrative auditor's report at Appendix 2

- Contain requirements which the auditor must comply with unless a particular ISA (UK and Ireland) or a requirement of an ISA (UK and Ireland) is not relevant.

Some ISAs (UK and Ireland) address the core aspects of planning and performing an audit of financial statements such as:

- Planning an audit
- Understanding the entity and its environment
- Identifying and assessing the risks of material misstatement
- Responding to assessed risks.

ISAs (UK and Ireland) also establish requirements in relation to those areas of the auditor's work where it is particularly important that the views of the auditor and users of financial statements regarding the nature and extent of work to be performed are aligned. Such areas include:

- Going concern
- The auditor's responsibility to consider fraud
- Consideration of laws and regulations.

Other ISAs (UK and Ireland) deal with more detailed matters such as audit sampling, written representations, using the work of an auditor's expert and using the work of internal auditors that may not be applicable on all audits.

In planning and performing the audit, amongst other matters, the auditor is required to:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit 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 Company's internal control.

- Obtain sufficient appropriate audit evidence regarding the financial information of entities and business activities within the group to express an opinion on the group financial statements. The auditor is responsible for the direction, supervision and performance of the group audit engagement and remains solely responsible for the auditor's opinion.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves a true and fair view.

- Communicate with [those charged with governance] regarding, among other matters, the planned scope and timing of the audit, the significant audit findings, and any significant deficiencies in internal control that the auditor identifies during the audit.

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The auditor also communicates with them regarding all relationships and other matters that the auditor believes may reasonably be thought to bear on the auditor's independence.

- As part of the audit, evaluate the directors' assessment of the entity's ability to continue as a going concern, including considering whether that assessment includes all information of which the auditor is aware as a result of the audit. The auditor concludes whether the directors' use of the going concern assumption in the preparation of the financial statements is appropriate. The auditor also concludes, based on the work performed, whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and is required to include that conclusion in the auditor's report. However, because not all future events or conditions can be predicted, the auditor's conclusion is not a guarantee as to the entity's ability to continue as a going concern.

- As part of the audit, read [all the financial and non-financial information in the *[annual report or other document containing the audited financial statements and the auditor's report thereon]*] and consider it in light of the knowledge of the entity the auditor acquired in the course of performing the audit to identify whether there is any information within it that is materially inconsistent with the audited financial statements or with that knowledge, or that is otherwise apparently materially incorrectly stated or presented or misleading. Based on reading and considering it, the auditor is required to report by exception if any such information was identified. However, the auditor does not audit this information and accordingly does not express an opinion on it.

Communicating with those charged with governance

As indicated above, the auditor is required to communicate the significant findings arising from the audit with those charged with governance. Those charged with governance are the persons with responsibility for overseeing the strategic direction of the entity and obligations relating to the accountability of the entity. This includes overseeing the financial reporting process.

Significant findings from the audit include:

(a) the auditor's view about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures;

(b) significant difficulties encountered during the audit; and

(c) significant deficiencies in internal control identified during the audit.

In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor is required to communicate to those charged with governance the information that the auditor believes will be relevant to:

(a) the board (in the context of fulfilling its responsibilities under Code provisions C.1.1 and C.2.1) and, where applicable, the audit committee (in the context of fulfilling its responsibilities under Code provision C.3.4); and

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(b) the audit committee (in the context of fulfilling its responsibilities under Code provision C.3.2) in order to understand the rationale and the supporting evidence the auditor has relied on when making significant professional judgments in the course of the audit and in reaching an opinion on the financial statements.

This should include the auditor's views:

(a) about business risks relevant to financial reporting, the application of materiality and the implications of the auditor's judgments on these matters for the audit strategy, the audit plan and the evaluation of material misstatements;
(b) on the effectiveness of the entity's system of internal control relevant to risks that may affect financial reporting;
(c) about other risks arising from the entity's business model and the effectiveness of related internal controls to the extent the auditor has obtained an understanding of these; and
(d) on any other matters identified in the course of the audit that the auditor believes will be relevant to the board or the audit committee in fulfilling the above responsibilities.

Reporting on the financial statements

The auditor's report is required to contain a clear expression of opinion on the financial statements taken as a whole.

To form an opinion on the financial statements the auditor concludes as to whether:

(a) the auditor has obtained audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion;
(b) uncorrected misstatements are material, individually or in aggregate;
(c) **[**the financial statements, including the related notes, give a true and fair view**]**[1]; and
(d) the financial statements are prepared, in all material respects, in accordance with the requirements of the relevant financial reporting framework, including the requirements of applicable law.

In particular an audit involves evaluating whether:

(a) the financial statements adequately refer to or describe the relevant financial reporting framework;
(b) the financial statements adequately disclose the significant accounting policies selected and applied;
(c) the accounting policies selected and applied are consistent with the applicable financial reporting framework, and are appropriate in the circumstances;
(d) accounting estimates are reasonable;
(e) the information presented in the financial statements is relevant, reliable comparable and understandable;
(f) the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
(g) the terminology used in the financial statements, including the title of each financial statement is appropriate.

[1] This conclusion is required only with respect to financial statements which have been prepared in accordance with a true and fair framework (examples are, International Financial Reporting Standards as adopted by the European Union and Generally Accepted Accounting Practice in Ireland (Irish GAAP)).

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Appendix 4 – Illustrative Scope of Audit Document consistent with the illustrative auditor's report at Appendix 2

Unqualified opinions
An unqualified opinion is expressed when the auditor is able to conclude that the financial statements **[**give a true and fair view and**]**[2] comply in all material respects with the relevant financial reporting framework (including applicable law).

Modified opinions
The auditor modifies the opinion when either:

(a) the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The auditor expresses a qualified opinion when either:

(a) misstatements, individually or in the aggregate, are material but not pervasive to the financial statements; or

(b) the possible effect of undetected misstatements, arising from an ability to obtain sufficient appropriate audit evidence, could be material but not pervasive.

The auditor expresses an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

The auditor disclaims an opinion when:

(a) the possible effect of undetected misstatements, arising from an inability to obtain sufficient appropriate audit evidence, could be both material and pervasive to the financial statements; and

(b) in extremely rare circumstances involving multiple uncertainties, the auditor concludes that notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Emphasising certain matters without qualifying the opinion
In certain circumstances an auditor's report includes an emphasis of matter paragraph to highlight a matter fundamental to the user's understanding of the financial statements. An emphasis of matter paragraph does not affect the auditor's opinion. The auditor is required to consider adding an emphasis of matter paragraph where there is a significant uncertainty the resolution of which is dependent upon future events and which may affect the financial statements. The auditor is required to add an emphasis of matter paragraph to highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.

Communicating "other matters"
If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment is relevant to user's understanding of the audit, the auditor's responsibility or the auditor's report, the auditor does so in a paragraph in the auditor's report with the heading "Other Matter" or other appropriate heading.

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[2] Only applicable with respect to "true and fair" frameworks.

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Appendix 4 – Illustrative Scope of Audit Document consistent with the illustrative auditor's report at Appendix 2

In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor includes in the auditor's report a section providing Auditor Commentary that highlights, without modifying the auditor's opinion on the financial statements, the matters that are, in the auditor's judgment, likely to be most important to users' understanding of the audited financial statements or the audit. The audit procedures relating to these matters are designed in the context of the audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures.

The auditor includes the following matters under Auditor Commentary:

(a) Cross-references to: the directors' statement in the Annual Report that the directors consider the annual report and accounts taken as a whole to be fair, balanced and understandable; and to the section of the Annual Report that describes the significant issues that the Audit Committee considered in relation to the financial statements and how these issues were addressed. The auditor confirms that the disclosures about the work of the Audit Committee include the issues which gave rise to the closest scrutiny, in the auditor's communications with the Audit Committee, of the various judgments made by the directors in preparing the financial statements;
(b) The risks that the auditor assessed to be significant to the audit and that, therefore, required special audit consideration;
(c) How the auditor applied the concept of materiality, both quantitatively and qualitatively in the planning and performance of the audit; and
(d) The implications of the assessed risks and materiality for the scope of the audit.

Other Legal and Regulatory Requirements
The auditor is required to address any other legal and regulatory requirements relating to the auditor's report in a separate section of the auditor's report following the opinion on the financial statements.

Other opinions prescribed by the Companies Act 2006

In addition to requiring the auditor to express an opinion on the financial statements, the Companies Act 2006 also requires the auditor to form and express an opinion as to whether the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

For quoted companies, as defined, the Companies Act requires the auditor to audit certain information that is required to be included in a Directors' Remuneration Report and to report whether such information has been properly prepared in accordance with the Companies Act 2006.

Matters on which the Companies Act 2006 requires the auditor to report by exception

The Companies Act 2006 further requires the auditor to carry out such investigations as will enable the auditor to form an opinion on:

- whether adequate accounting records have been kept by the company and returns adequate for the audit have been received from branches not visited by the auditor;
- whether the company's individual accounts are in agreement with the accounting records and returns; and

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- 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.

The Companies Act 2006 requires the auditor to state in the auditor's report where:

- the auditor fails to obtain all the information and explanations which to the best of the auditor's knowledge and belief are necessary for the purposes of the audit;
- the directors have prepared accounts in accordance with the small companies regime or have taken advantage of the small companies exemption in preparing the directors' report and in the auditor's opinion they were not entitled to do so; and
- a corporate governance statement has not been included in the directors' report and it appears to the auditor that a corporate governance statement has not been prepared.

Although the Companies Act 2006 requires the auditor to report on the above matters by exception, ISA (UK and Ireland) 700 requires the auditor to incorporate a suitable conclusion on such matters within the auditor's report.

If the requirements of:

- certain regulations regarding the disclosure of directors' benefits; remuneration, pensions and compensation for loss of office are not complied with in the annual accounts; and
- in the case of a quoted company the requirements of regulations as to information forming the auditable part of the directors' remuneration report are not complied with in that report

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

Matters which the Listing Rules require the auditor to review

With respect to companies having a premium listing of equity shares, the UK Listing Rules require the auditor to review:

- the directors statement on going concern;
- the part of the Corporate Governance Statement relating to the company's compliance with the following nine provisions of the UK Corporate Governance Code (C.1.1; C.2.1; and C.3.1 to C.3.7);
- certain elements of the report to shareholders by the Board on directors' remuneration (and the auditor must include in the auditor's report, to the extent possible, details of the non-compliance.).

Reporting on matters the auditor is required to report on by exception

Where the auditor is required by law, regulation or the ISAs (UK and Ireland) to report on a matter by exception, ISA (UK and Ireland) 700 requires the auditor to incorporate a suitable conclusion on those matters in the auditor's report. Accordingly, the auditor's report includes a conclusion on such matters, including the following:

- their review of the directors' statement on going concern, required under the UK Listing Rules, and their conclusion as to whether a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern;
- their review of other matters required under the UK Listing Rules;

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- their review of [*the annual report or other document that contains the audited financial statements and the auditor's report thereon*] – in particular, the auditor states whether the auditor has identified any inconsistency with the audited financial statements or their knowledge of the entity acquired in the course of performing the audit;
  In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor states whether the auditor identified any inconsistency with the auditor's knowledge regarding the directors' statement that the annual report is fair, balanced and understandable and confirms whether the annual report appropriately discloses those matters that the auditor communicated to the Audit Committee and that the auditor considers should have been disclosed; and
- those matters the auditor is required to report on by exception in accordance with the Companies Act 2006.

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