17th April 2013

Steven Leonard
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The Financial Reporting Council
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Dear Steven,

The Financial Reporting and Analysis Committee (FRAC) of the Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to respond to the proposed revisions of the ISA (UK & Ireland) 700 auditing standards by the Financial Reporting Council (FRC).

CFA UK represents more than 10,000 investment professionals working across the financial sector. For advocacy purposes in the field of financial reporting, these members are represented by the Financial Reporting and Analysis Committee. Our responses have been informed by committee meetings and consultation with our members.

Overall
We welcome these proposals to improve the auditor's report, following last year's stimulating consultation by the IAASB. The initiative will also build on the FRC's efforts to improve reporting by the audit committee and to encourage effective company stewardship.

Any analysis of the risks of material misstatements in the audited accounts is likely to prompt more rigorous questioning of the company and its auditors. A question not addressed in this consultation is what enhanced opportunities there might be for such questioning by investors, bearing in mind the concentrated nature of the annual meeting season. The increased use of webcasts and other web-based opportunities for Q and As may need to be considered.

Question 1: Do you agree that the auditor's report should include a description of the auditor's assessed risks of material misstatement, materiality and the audit scope? If not, why not?

CFA UK would like to see disclosure of the risks of material misstatement, materiality and audit scope in an auditor's report. We think that this will lead to greater transparency from auditors and useful information for investors – the "hooks" for engagement that have frequently been referred to. But we are aware that the auditor will feel constrained, partly because of the client relationship and partly because of the potential sensitivity of publicly disclosing internal debates about key judgments.

We have two concerns over the implementation:
1. *Potential focus on process*: the proposed amendments to ISA 700 may result in auditors focusing on the process of the audit rather than the key judgment that were made. We believe that investors are less likely to be interested in, for example, the number of sites that an auditor has visited than the debates over what was measured and how. This difference should be made clear in the amendments.

2. *Risk of non-disclosure from public sensitivity*: there is a risk that the auditor may not mention something because it is wary of sensitive information becoming public. This could be more of an issue if the auditor's report is expected to focus on issues that the audit committee does not discuss in its report.

Question 2: Do you agree that these proposals should be limited to entities that explain how they comply with the Code? If not, why not?

Yes. There is little need for private companies to issue this level of detail. However, if the company has accessed bond markets, or if it plans to float on the stock market, then such measures could be considered on a voluntary basis. There might be a case for applying the requirement to "public interest" credit institutions, such as building societies whose members would be interested in the auditor's view. If there were plans to expand the scope to private companies, then there should be a minimum threshold for the company size.

Question 3: (a) Do you consider that the provision of such information by the auditor will be of benefit to shareholders and other users of the financial statements and, if so, can you explain what those benefits would be and how they would arise?

Yes, we believe that the statements would be beneficial to shareholders and other investors. We see two main benefits to shareholders:

1. *Increased risk disclosure*: The main benefit to investors would be if the report identifies risks that are either difficult for investors to weigh up or inadequately disclosed elsewhere. Current risk disclosures are often not prioritised and the explanations of the most significant risks are too basic. The auditor's report could really add value by providing analytical information about the judgments that make the most difference in assessing a company's financial performance and soundness. This means the most important discussion will be about the risk of material misstatement, while it will also be useful to have a better feel for materiality criteria and the scope of the audit, rather than the current box-ticking exercise.

2. *Internal discussions*: It would be useful to know more about the discussions between the auditor and the audit committee. What were the key subjects drawn to the committee's attention? Was there a range of views? How did the auditor become comfortable with the most difficult judgments behind the numbers that ended up in the accounts?

(b) Do you believe such information would provide an effective "hook" for investors and other users to start a dialogue with the company about the audit?

Yes. We think that such information will help initiate a dialogue with investors and the company on the key audit decisions. The emphasis on company specific issues is welcome and will help with this.

Question 4: Do you believe that directors are likely to disclose information about the audit (of the type that would be required in accordance with these proposals) under the September 2012 changes to the Code? Is it more appropriate for such information to be provided in the auditor's report or by the board in the section of the annual report addressing the work of the audit committee, and why?

We realise that the auditor is not going to give alternative numbers to those in the audited accounts. However, if there were no numbers in the auditor's report then it could be a missed opportunity. One way of supplementing the audited accounts would be to provide a benchmark analysis of the approach taken by other companies to similar measurement issues. This would help prompt a dialogue with investors as to why the company chose one approach over another.

Another approach might be for the auditor to describe the range of potential outcomes, depending on sensitivity to the key assumptions. It could then give a "confidence accounting" explanation of why it was, for example, 95% confident that the number in the accounts was at the optimum point in the range.

Question 5: What do you believe would be, if any, the benefits, costs and other impacts of the proposed requirement to describe in the auditor's report certain risks of material misstatement that were identified by the auditor?

We do not think that there will be a much greater cost in producing the auditor's report because most of the material should already be available in the exchanges between auditor and audit committee. There will be benefits to investors as outlined above.

Question 6: Do you agree that the basis for determining the risks of material misstatement to be described in the auditor's report (see proposed paragraph 16A(a) of ISA (UK&I) 700) is appropriate?

We think that the proposals go into too much detail on materiality. The over-riding factor should be whether omitting or misstating the information could influence a shareholder or creditor's decision.

Question 7: The risks disclosed by the auditor in complying with proposed paragraph 16A(a) of ISA (UK&I) 700 may well differ from the principal risks disclosed by the directors in the business review in the annual report. What are your views about this possibility?

We think it is important that the auditor's report focuses on the risks of material misstatement of a company's profits, cash flow and financial position. The directors' catalogue of principal risks ranges more widely. Where there is overlap, the audit committee and the auditor can provide a more detailed and analytical account of the financial issues. There could be cross-references to minimise duplication.

Question 8: Do you believe that the omission from the auditor's report of a particular risk of material misstatement would pose a threat of significant loss or damage to the auditor if, after the event, it became evident that the risk had given rise to significant damage to the company?

Yes.

Question 9: How do you assess the benefits, costs and other impacts of the proposed requirement to provide in the auditor's report an explanation of how the auditor applied the concept of materiality in planning and performing the audit, including specifying the threshold used by the auditor as being materiality for the financial statements as a whole, and the balance between them?

We would caution against having boilerplate descriptions in this section. Investors would obtain more value here from the qualitative, company-specific elements rather than details of the calculation of the threshold.

Question 10: How do you assess the benefits, costs and other impacts of the proposed requirement to provide in the auditor's report a summary of the audit scope, and the balance between them? Does the illustrative disclosure in Section 3 provide a sufficient explanation of how the audit scope was responsive to the auditor's assessment of risks and materiality?

This illustration is too focused on process. The most interesting part concerns the material risks of mis-statement, so the bullet points in the first segment should be expanded. Also the heading of this section sounds like it is focused on risks to the auditor, not on the risk that investors will either be misled by potential misstatements – or place too much reliance on a number that is very sensitive to certain assumptions.

The "auditor commentary" in the IAASB's 2012 publication, "Improving the Auditor's Report", is more interesting since it sets out to highlight matters that are "likely to be most important to users' understanding of the audited financial statements or our audit".

Question 11: Do you believe that the wording of paragraph 16A and paragraphs A9A to A9Cis sufficiently principle-based so as to avoid standardised language?

These sections are not sufficiently principles-based and so will encourage auditors to give details of what they did, rather than tell investors why certain numbers are at risk of material misstatement, how the auditor tackled the issue with the company, and on what basis agreement was reached on the number in the accounts.

Question 12: Do you foresee any difficulty if the effective date is periods commencing on or after 1 October 2012?

No.

We look forward to discussing the issues raised in this response.

Yours sincerely,

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