CIPFA The Chartered Institute of Public Finance & Accountancy

Proposed revisions to International Standards on Auditing (UK and Ireland) to give effect to the FRC Effective Company Stewardship proposals:

- 260 “Communication with those charged with governance”

- 265 “Communicating deficiencies in internal control to those charged with governance”

- 700 “The auditor’s report on financial statements” (Revised)

- 720A “The auditor’s responsibilities relating to other information in documents containing audited financial statements”

response to consultation paper

19 July 2012

the people in public finance

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed.

As the world's only professional accountancy body to specialise in public services, CIPFA's portfolio of qualifications are the foundation for a career in public finance. They include the benchmark professional qualification for public sector accountants as well as a postgraduate diploma for people already working in leadership positions. They are taught by our in-house CIPFA Education and Training Centre as well as other places of learning around the world.

We also champion high performance in public services, translating our experience and insight into clear advice and practical services. They include information and guidance, courses and conferences, property and asset management solutions, consultancy and interim people for a range of public sector clients.

Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance. We work with donors, partner governments, accountancy bodies and the public sector around the world to advance public finance and support better public services.

Our ref: Responses/ 120719 SC0182

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19 July 2012

Dear Keith

Proposed revisions to International Standards on Auditing (UK and Ireland) to give effect to the FRC Effective Company Stewardship proposals

Background

This consultation has been issued as part of the *Effective Company Stewardship* project. CIPFA did not provide a response to the mainly company focussed consultation carried out in 2011, although we reviewed the proposals having regard to the potential for adapting any improvements for use in the public sector context. The project brings together thinking on financial reporting, governance and audit, and follows up FRC operating body projects on improving audit quality and improving annual reports to which CIPFA has responded.

In principle we support measures which might lead to a clearer demonstration of what auditors are achieving and increased insight into the audit process, but as explained below, we have some reservations about the proposals included in this consultation.

Related developments and initiatives

In April 2012, the European Commission set out proposals for audit reform, following consultation conducted in late 2010, which are now being considered through the EU legislative process. Initial reactions from the audit profession in the UK and Europe more generally identified some aspects of the proposals which might be overly prescriptive, and in some cases might not be effective. We note the FRC's view expressed in the main *Effective Company Stewardship* Consultation Document on the proposals is that 'targeted and proportionate action to improve practice at national level may help to alleviate the pressure for more prescriptive action at EU level'. While we support the intentions of the FRC, it is not clear that the FRC work will have any significant influence on what happens at EU level, particularly insomuch as it would be difficult to generalise the FRC model to EU Member States which do not have a mature audit committee culture or equivalent governance framework.

Although the difficulty of developing a solution which works for all EU member states should not be underestimated, the EC proposals have given additional impetus to work by the IAASB on its auditor reporting project. In June the IAASB issued an Invitation to Comment document *Improving the Auditor's Report*. The IAASB work has been informed by development in various national contexts including the UK, and the Task Force for the Auditor Reporting project includes Jon Grant, UK IAASB Board member and previously APB Technical Director.

Against this background, we have concerns that this may not be the best time for the FRC to develop unilateral proposals on this topic.

Adoption of ISAs in the European Union

In common with the other accountancy bodies in the UK and Ireland which are members of FEE and IFAC, CIPFA supports the adoption of ISAs internationally, and specifically in the European Union. We reiterated this position in September 2009 in our response to the European Commission on its *Consultation On The Adoption Of International Standards On Auditing (ISAs)*.

In that response we strongly advised against the introduction of add-ons or carve-outs by Member States, expressing concern that a lack of consistency in the introduction and implementation of the standards across the EU would undermine the benefits of common auditing standards.

While the initial reformulation of UK auditing standards as ISAs (UK & Ireland) in 2004 included a large number of ISA pluses, we were very glad to see that these were substantially eliminated during the 2009 adoption of clarified and improved ISAs. The APB has also used its existing regime of Practice Notes, Bulletins and other guidance to avoid the need to include within ISAs the wide variety of regulatory arrangements which apply in specific economic sub-sectors such as government, charities, insurance, pensions and investment businesses.

The current proposals include further requirements formulated as 'ISA pluses'. Particularly for those which embody regulatory requirements which apply only to specified audits, it might be helpful to distinguish these from the body of the internationally agreed ISAs by publishing them in separate documents to be used by those auditors to whom the additional requirements apply (ie auditors of entities which apply the UK Corporate Governance Code), much in the way that sector specific regulatory requirements are set out in Practice Notes and Bulletins. Presentation in a separate document might also allow for clearer drafting, and might thereby avoid some CIPFA concerns

Concerns about possible unintended consequences of some of the proposed pluses

Apart from the questions of timing and the placement of guidance we have significant concerns about the specific content of some of the proposed pluses to the ISAs (UK & Ireland), as set out below.

Proposed changes to

- ISA (UK & Ireland) 260, relating to the auditor's communications to audit committees, including the auditor's judgement on matters which might be relevant to audit committee advice to the Board on the annual report for UK Corporate Governance Code purposes ;

and

- ISA (UK & Ireland) 265, relating to communication to the audit committee of auditor views on the effectiveness of the entity's system of internal control based on audit procedures performed in the audit of the financial statements.

We can see that these proposals are meant to encompass and mainly to describe procedures which are carried out in well run audits (regardless of the applicability of the Code), and are not intended to affect the quantum or quality of work carried out during mainstream audit testing. However, the introduction of a communication requirement may have the effect of increasing efforts beyond the level previously considered to be an appropriate, defensible level of work in compliance with ISAs (UK & Ireland) and other applicable guidance. The requirement to report may be particularly problematic in cases where no significant matters have been observed during mainstream audit testing.

Furthermore, notwithstanding other guidance which places primary responsibility on management and the audit committee, the requirement for auditor reporting may have the effect of de-emphasising the audit committee responsibility to review the company's internal control and risk management systems. Particularly in situations where auditors convey a positive message based on limited procedures that they have performed for the purpose of the audit, there is a risk that an expectation gap will be created with audit committees placing undue weight on external audit as evidence that systems of internal control are sound and adequate, rather than their own understanding and judgement informed as appropriate by the work of internal audit.

The proposed requirement in ISA (UK & Ireland) 700 to report by exception if the board's statement in the annual report setting out why it considers that the annual report is fair, balanced, understandable etc., is inconsistent with the auditor's knowledge acquired in the course of performing the audit.

CIPFA supports the intention behind this proposal, and we support the more generally applicable changes proposed to ISA (UK & Ireland) 720A paras 6 and 6-1, which provide an improved description of the knowledge of the auditor.

However, as regards this specific proposal for ISA (UK & Ireland) 700, clear guidance would be needed for boards and auditors in order for them to be able to meet this requirement. Furthermore, while in some cases it will be very straightforward for auditors to determine that the annual report is not understandable, we can envisage many borderline cases where it is difficult to resolve the tension between under-explanation of 'somewhat material' matters and over-explanation or 'clutter'.

We also wonder if the effect of this reporting would be to increase the involvement of board members and audit partners in an iterative process which gives rise to nil report by the auditor. While we can see that this may have benefits for accountability and the transparency of the eventual reporting, the additional costs may not be insignificant.

I hope this is a helpful contribution to this discussion. If you have any questions about this response, please contact Steven Cain (e:steven.cain@cipfa.org.uk, t:+44(0)20 7543 5794).

Yours sincerely

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ANNEX A

Responses to specific questions

Q1: Is the scope of the proposed changes appropriate? If not, please explain the scope you consider would be appropriate.
CIPFA agrees that the scope of most of the proposals be restricted to UK Code reporting entities; we agree that there is no need to amend ISA (UK & Ireland) 600 to implement these proposals. CIPFA agrees that there is no justification for extending to all audits the reporting requirement to provide an explicit conclusion arising from the auditor's work under ISA (UK & Ireland) 720 Section A.
Q2: Is the proposed effective date, which is linked to the intended effective date of the FRC's proposed revisions of the UK Corporate Governance Code, appropriate? If not, please give reasons for your view and indicate the effective date that you would consider appropriate.
As noted in our covering letter, we have concerns that this is not the best time to make changes to the UK and Ireland auditing standards.
Q3: Are the proposed changes to ISAs (UK and Ireland) 260 and 265 appropriate? If not, please give reasons and, if applicable, indicate how you believe they should be modified.
As noted in our covering letter, we have concerns over the possible effects of the proposed changes. As drafted there is a risk that the role of the audit committee is de-emphasised, based upon inappropriate expectations of the external auditors.
Q4: Are the proposed changes to ISAs (UK and Ireland) 700 (Revised) and 720 Section A appropriate? If not, please give your reasons and, if applicable, indicate how you believe they should be modified.
As noted in the covering letter, CIPFA has some concern that it will be difficult to apply the requirement in the proposed ISA (UK & Ireland) 700 to report by exception if the board's statement in the annual report setting out why it considers that the annual report is fair, balanced, understandable etc., is inconsistent with the auditor's knowledge acquired in the course of performing the audit

Q5: Do you agree that it would be inappropriate to extend to all audits the reporting requirement to provide an explicit conclusion arising from the auditor's work under ISA (UK and Ireland) 720 Section A? If not, please give your reasons.
We agree that there is no justification for extending to all audits the reporting requirement to provide an explicit conclusion arising from the auditor's work under ISA (UK & Ireland) 720 Section A.
Q6: Do you agree that the associated costs of the proposed changes should not be significant compared to total audit costs? If not, please give reasons and your estimate of the level of impact. **Q7: Do you agree that the benefits of the proposed changes will outweigh any costs? If not, please give reasons.**
Given that CIPFA's principal focus is on public sector reporting, we have no observations to make on the assessment of cost and benefit.