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Dear Steve

Revision to ISA (UK and Ireland) 700 - Requiring the auditor's report to address risks of material misstatement, materiality and a summary of audit scope

Ernst & Young is pleased to have the opportunity to respond to the above consultation paper. We are also grateful to the FRC for organising the public meeting on 28 March 2013 at which these proposals were discussed – we found the discussion helpful in developing our responses to these proposals.

We believe that there is widespread agreement amongst all interested parties that significant changes are required to the audit report to address the concern that the current version is a “boiler plate”, binary report which does not communicate information of value about the audit to users of the financial statements. We are strongly supportive of all efforts to “add value” to the audit report.

We have considered these current proposals very much in the context of the current UK position and in particular in the light of the changes to the UK Corporate Governance Code and to ISAs (UK & Ireland) 260 and 700 introduced in October 2012. The current proposals are clearly intended to complement and complete those earlier changes. Indeed the proposals can really only be understood in the context of the earlier changes and the FRC’s approach to improving the quality of reporting.

In that context we are in favour of introducing the changes proposed by the FRC. We believe that the combination of the additional reporting on “audit inputs” proposed here and the requirement under the October 2012 ISA 700.22B to report by exception if the audit committee report does not appropriately address matters communicated to it by the auditor, will significantly increase the value of the auditor’s report to investors. We note that the issues of materiality, audit scope and audit risks are critical inputs to the audit planning process which could make the auditor’s report more informative to shareholders.

We recognise that there may be some investors who would prefer a more explicit communication of the issues raised by the auditor with the audit committee in the auditor’s report rather than in the audit committee report. This concern was raised at the public meeting. However, a post-implementation review of the feedback from stakeholders on the effectiveness of this reporting model will enable the FRC to rechallenge its thinking if necessary, while also considering the experience of the IAASB and others to improve audit reporting.

We do not believe adopting these proposals will create excessive difficulties for auditors. We recognise the risk concerns highlighted in the paper but on balance our view is that any risk lies more with the failure to identify the risk and address it in the audit than the failure to report it. Realistically the proposals will lead to certain cost increases, something which was discussed at the public meeting. Whilst the proposed new content of the report will probably reflect the summarisation of the existing content of audit committee reports, that summarisation and the related review process will incur more time for senior members of the audit team and there will almost certainly be further discussions between the audit team and those charged with governance. We would anticipate that these additional costs will be relatively limited in many cases but the actual costs will be driven by the circumstances of the specific company.

Notwithstanding this, we would nevertheless recommend that mandatory implementation be delayed until 31 December 2013 as we think any earlier timetable may not allow auditors sufficient time to consider the full implication of these changes for their report.

We have attached as Appendix I our responses to the specific questions raised in the consultation paper. However more generally we think the FRC should consider whether it would be appropriate to issue more guidance to audit committees and auditors about the application of the Code and the related ISAs. We understand the FRC's desire to encourage company specific reporting and to avoid "boiler plate" wording in either audit committee reports or audit reports, which further guidance might be thought to encourage. However we suspect there may be points of principle where FRC guidance might be helpful in achieving consistency. For example, in the public meeting, during the discussion of materiality, a comment was made to the effect that investors might be more interested in the magnitude of unadjusted audit differences than in the absolute amount of planning materiality. Our view is that unadjusted audit differences are one of those things communicated to the audit committee by the auditor to be considered for disclosure in the audit committee's report under 5.2 of Guidance on Audit Committees but we could see a diversity of view on this.

If you would like to discuss any aspect of this response further please do not hesitate to contact me

Kind regards

Yours sincerely

Robert Overend
Ernst & Young LLP

Appendix I – Response to Detailed Questions

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?*

Yes we support the FRC's proposals to include such descriptions in the audit report for the reasons set out in our covering letter.

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 we agree that they should be limited to entities complying with the Code. As we note in our covering letter these changes complement previous changes to ISA 700 which apply to those entities complying with the Code

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?

(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?

Clearly the views of investors/shareholders are the most relevant in responding to these questions. Based on the discussions we have had with investors we do think the proposals will be of benefit to investors. The disclosures will address at least in part the concern that the audit is a "black box" which investors have indicated they have no insight into. Furthermore in conjunction with the enhanced audit committee reports required under the October 2012 Guidance on Audit Committees we believe the proposed additional information will provide a starting point for improved dialogue with the Audit Committee Chairman about key aspects of the audit. The ultimate value of such dialogue will of course depend fundamentally on the willingness of investors and Audit Committee Chairmen to engage appropriately.

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 assessing the work of the audit committee, and why?*

At this stage it is difficult to be definitive about what will be included within the audit committee's report in the light of the requirements of C.3.8 of the Code and paragraph 5.2 of the Guidance on Audit Committees. However given that the focus of that reporting is the "significant issues the committee considered in relation to the financial statements" we would not have expected that the type of information required under these proposals to be included in most cases.

We think that it is appropriate that information of the type required by these proposals is included in the auditors' report

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 are identified by the auditor?*

The benefit as discussed above will be to provide greater insight for shareholders about the audit process which in turn will help them to engage with the audit committee about aspects of the audit which may be of interest to them. As we note in our covering letter we believe that there will be cost implications of such additional reporting especially as the additional audit time required will be from senior members of the engagement team. However we think those additional costs will be relatively limited in many cases, although the actual costs will be driven by the circumstances of the specific entity.

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

We believe that the basis suggested in paragraph 16A is appropriate. However we think it would be helpful if 16A made explicit the point in paragraph 3 of the consultation paper that these risks are not necessarily coincident with those risks identified as significant in accordance with ISA (UK&I) 315 and that it is for the auditor to determine which of the significant risks and other identified risks of material misstatement should be described. In reaching this judgement the auditor is likely to consider the amount of time spent discussing such risks with management and the audit committee (and the extent of discussion in the report to those charged with governance) and explicit guidance on this point would probably be helpful

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 on this possibility?*

We do not view this possibility with concern. We believe there will be an understanding by users of the reason for differences. If the differences do give rise to concerns, this will, in turn, provide a hook for the shareholder to engage with the audit committee about the scope and rigour of the audit.

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?*

As noted in our covering letter we believe the risk of loss or damage to the auditor is more likely to arise from a failure to identify the risk and apply appropriate audit procedures than in the failure to report the risk in the auditor's report.

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 support this aspect of the proposal. We see the benefits as being able to provide greater insight into the audit process. There will be additional audit costs but we see them as being manageable.

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 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?*

We support disclosure on audit scope and believe that the balance of costs and benefits are consistent with the requirements for risks and materiality.

As regards the detailed application of these requirements as set out in A9C and the illustrative report we have a number of concerns which we believe the FRC should consider. As drafted the illustrative report could be read to suggest that work at all locations was performed by the firm signing the audit report whereas often some of this work will have been performed by network or other firms. This raises a linked question of whether this disclosure is intended to provide an analysis of the extent of work performed by the signing audit firm, other network firms of the signing firm and other non-network firms. We suspect that investors would find such disclosure of value in engaging with the audit committee. However we are concerned that such disclosure in the auditor's report could be seen as undermining the principle that the group auditor takes full responsibility for the group audit. We were also concerned by the implication in A9C that the group auditor would undertake substantially different procedures in relation to non-network as opposed to network component auditors, whereas we believe the requirements of ISA 600 apply equally to both, albeit ISA 600 recognises that the group auditor may be able to utilise knowledge of network firms in performing that work (ISA (UK&I) 600.A33).

In summary we think that the FRC should reconsider its detailed requirements and guidance in this area such that the audit report addresses solely the scope of work done at relevant components rather than seeking to address which firm has undertaken the work. Disclosure of the involvement of non-network firms should be made in the audit committee report as this normally arises from decisions made by the audit committee which it can explain in its report.

Question 11: *Do you believe that the wording in paragraph 16A and paragraphs A9A to A9C is sufficiently principle-based so as to avoid standardised language?*

We believe that the language is appropriately principles-based. Even with such wording some degree of "standardisation" is likely to develop over time.

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

As we note in our covering letter, application of these new requirements will present an implementation challenge. We would prefer that December 2013 year end audits were the first to be subject to mandatory adoption.