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Financial Reporting Council
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By post and email: k.billing@frc-apb.org.uk

Dear Keith

Revisions to the ISAs (UK & IRE)

We are pleased to respond to the FRC's *Proposed revisions to International Standards on Auditing (UK and Ireland) to give effect to the FRC Effective Company Stewardship Proposals* ("the Consultation").

These proposals, although directly relevant to the UK and Ireland, must be seen in the context of the wider current debate on the role of the auditor and the challenge to make auditor reporting more effective and valuable. Accordingly, in developing our response, we have consulted with colleagues in other member firms of Ernst & Young Global.

Our responses to the detailed questions raised in the Consultation are provided in the appendix to this covering letter which sets out our general observations on the FRC's proposals.

We have been, and remain, supportive of the FRC's Effective Company Stewardship proposals. Once implemented, we believe they will contribute to greater transparency in corporate reporting and as such enhance stakeholder confidence. By extension we are also strongly supportive of changes which will make more transparent the role of the auditor and enhance the effectiveness of auditor reporting. Although we support the principles underpinning the proposals in this Consultation, we have two concerns.

Firstly, as we allude to above, these proposals are issued against the background of a wider debate on enhancing the effectiveness of auditor reporting. In particular, the IAASB has just issued an 'Invitation to Comment' to solicit feedback on its suggested improvements to the auditor's report. We are unclear from the Consultation how the FRC has anticipated the potential impact of changes to ISAs which may emerge from the IAASB, assuming the FRC will follow past practice and incorporate changes in ISAs into ISAs (UK and Ireland). Accordingly, we believe it is critical that as the FRC develops its proposals, it continues to monitor and influence the IAASB's work in this area.

Secondly, we are concerned that the proposals as currently drafted - whilst reflecting the requirements in the revised UK Corporate Governance Code and Guidance on Audit Committees - do not provide guidance to auditors on the detailed application of these requirements. We recognise that the FRC wishes to establish the broad principle and we agree that it would not be appropriate to seek to bind that principle with excessively detailed guidance. Nevertheless, we do believe that the FRC should seek to develop a bulletin (or possibly revise bulletin 2006/5) to provide greater guidance to auditors on the practical considerations of these enhanced reporting requirements.

In practice we believe that it would make sense to develop that guidance before the proposed revisions to the ISAs (UK & IRE) are finalised. As described more fully in our appendix, we believe some of the proposed amendments (for example the proposed new 9-1 of ISA 265) are unclear and we believe that the preparation of the additional bulletin guidance could inform the clarification of the underlying requirement.

If you would like to discuss any of our views please contact me using the details above. In the meantime we wish you every success with the rest of the consultation. For the avoidance of any doubt, this is not a confidential reply.

Yours sincerely

Robert Overend

Robert Overend
Partner

Appendix - Responses to questions raised in the Consultation Paper

Q1 Is the scope of the proposed changes appropriate? If not please explain the scope you consider would be appropriate.

We agree with the proposed scope of the new requirements.

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 you would consider appropriate.

We agree with the proposed effective date.

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 the covering letter we believe that the FRC should seek to develop a bulletin or revise bulletin 2006/5 to provide further guidance to auditors on the practical application of the new requirements.

We believe that the proposed additional 16-1 of ISA 260 is appropriate. We are however concerned that the inclusion of sub para (a) of this new section should not lead to any confusion or ambiguity as to the overriding obligation of the directors to consider the materiality of misstatements and to confirm to the auditor their conclusion. We ask the FRC to consider how best to reinforce this principle.

We believe that the proposed A7-1 of ISA 260 might be better incorporated as A6-1 given the nature of its content.

As noted in the covering letter, we find the drafting of the proposed 9-1 of ISA 265 unclear. In particular, the first sentence is long and complex. It has the effect of mixing up what the FRC appears to envisage as two distinct requirements in relation to controls effectiveness and risks.

We agree with the FRC that effective communication of the auditor's evaluation of the entity's controls will be helpful to audit committees. However, we are not clear as to how the FRC envisages this requirement will be met. The communication is clearly intended to go beyond the identification of control deficiencies already required by ISA 265, but the current proposals provide no "framework" as to how the "auditor's views on the effectiveness of the entity's system of internal control" can best be articulated. Without such a framework, and notwithstanding the cautionary language in the final sentence of 9-1 and A12-3, we are concerned about a further widening of the expectation gap.

The latter paragraph (A12-3) could be revised, to provide further caution by adding that the "auditor's risk assessment procedures are based on professional judgement which only" includes consideration of internal controls relevant to the preparation of the financial statements. However, it may be that the most helpful way for the auditor to communicate this assessment, and manage expectations, is through a much more detailed description of how the evaluation and testing of controls have been applied in the audit process (an an account-by-account and/or component-by-component basis) and the results of that audit work.

Proposed section 9-1, when read in conjunction with proposed section A12-3, requires the auditor to report to the audit committee risks arising from the entity's business model which, in the opinion of the auditor, should be disclosed in the annual report. Again we are concerned that in the absence of guidance as to how to evaluate the significance of risks, auditors will struggle to apply this requirement. Furthermore, we suspect the FRC's underlying objective in this regard will be met through the requirements imposed in ISA 720. Therefore, if the auditors have identified a risk when conducting an audit, which causes them to question the board's statement on why it considers the annual report is fair, balance and understandable, the auditors will resolve that concern with those charged with governance as required by ISA 720 A4-2 (or report by exception if not).

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.

We are comfortable that these proposals are appropriate, but we believe further guidance on how auditors should evaluate the board's statement will be necessary. We encourage the FRC to apply a broad perspective when considering the depth and breadth of this future guidance, to help ensure it is comprehensive and useful to auditors.

Q5 Do you agree that it would be inappropriate to extend to all audits the reporting requirements 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 with the proposed limitations in this area.

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 your reasons and your estimate of the level of impact.

We agree that the associated costs of the proposed changes should not be significant. However, it is difficult to measure cost in this context given the need for guidance, implementation measures and the time required of auditors to consider the future application of these changes.

Q7 Do you agree that the benefit of the proposed changes will outweigh any costs. If not please give reasons

In the absence of more specific guidance, which we believe is critical to the successful implementation of these changes, it is difficult to answer this question. That said, we suspect that the additional costs will be more significant than the FRC currently envisages. However, we believe there is considerable value in enhancing the effectiveness of audit reporting. Therefore, we anticipate that the benefits will outweigh the costs, notwithstanding the difficulty in measuring the costs and benefits.