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Dear Mr Gunn

Exposure Draft – ISA 720 (Revised)

The Financial Reporting Council (FRC) welcomes the opportunity to comment on proposed ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*.

We believe that the extant ISA 720 is in need of revision to better meet the reasonable expectations of users. In particular, we strongly support the proposal that auditors consider other information in light of their understanding of the entity and its environment. Accordingly, we are supportive of the aims of the IAASB in revising the ISA and in general we agree with the proposals in the exposure draft. However, we do have some recommendations for improvements with regards to some of the specific proposals, which are explained in our responses below to the request for specific comments. In particular, we believe that the proposed statement to include in the auditor's report will not be sufficiently clear to users and we recommend revised wording in our response to question 11.

Responses to request for specific comments

Scope of the proposed ISA

1. *Do respondents agree that there is a need to strengthen the auditor's responsibilities with respect to other information? In particular do respondents believe that extending the auditor's responsibilities with respect to the other information reflects costs and benefits appropriately and is in the public interest?*

We agree that it is appropriate to extend the auditor's responsibilities with respect to other information as proposed in the exposure draft. Some users will believe that auditors are already performing at least the procedures set out in the exposure draft, particularly considering whether the other information is consistent with the auditor's knowledge, and therefore these proposals should assist in reducing the expectation gap in this respect.

We believe that stakeholders do not want full audit assurance on 'other information', but that they do believe auditors could add some value in relation to it, based on their audit knowledge, and that the benefits of that would outweigh the costs of what they think should not be a significant incremental increase in audit work. We do not have data to enable us to estimate the specific impact on audit costs of the proposals in the exposure draft. However, auditors are not being required to undertake substantially more verification procedures and, therefore, we believe the incremental costs of the proposed changes should not be significant compared to total audit costs.

2. *Do respondents agree that broadening the scope of the proposed ISA to include documents that accompany the audited financial statements and the auditor's report thereon is appropriate?*

We agree in principle with the inclusion of 'accompanying documents', as defined in the exposure draft, within the scope of the proposed ISA but we also recognise that this creates definitional complexity in relation to the scope of the ISA as discussed further in our response to question 3. Nonetheless, we support it because we believe it will help increase consistency of auditors' consideration of information published with audited financial statements.

3. *Do respondents find the concept of initial release clear and understandable? In particular, is it clear that initial release may be different from the date the financial statements are issued as defined in ISA 560?*

We find the concept of 'initial release' as illustrated in paragraph A4 of the application material clear and recognise that it is an important factor in identifying what are the 'accompanying documents' that fall within the scope of the proposed ISA. However, despite the guidance in paragraph A5, we can envisage that in practice some entities and their auditors may be uncertain which documents, if any, are deemed to be issued in connection with the initial release. This will, to some extent, remain a matter of judgment and we think it would be difficult to be more precise in defining this given the variety of circumstances that arise internationally and the evolving nature of corporate reporting.

In some jurisdictions, as recognised in paragraph A5, established laws, regulations, custom or practice may dictate information that is released in connection with the financial statements. For such jurisdictions the ISA should recognise that national standard setters and/or regulators may determine the information that is to be regarded as issued in connection with the initial release of the audited financial statements. In principle, this could be achieved by adopting a similar approach to that taken in ISA 550 whereby if the applicable financial reporting framework defines 'related parties' that definition is used for the purpose of the ISA. The application material at paragraph A5(a) could be modified by adding the following: "... and the auditor is expected to have at least some regard to those documents under law or regulation, or established custom or practice; or".

4. *Do respondents agree that the limited circumstances in which a securities offering document would be in scope (e.g., initial release of the audited financial statements in an initial public offering) are appropriate or should securities offering documents simply be scoped out? If other information in a securities offering document is scoped into the requirements of the proposed ISA in these circumstances, would this be duplicating or conflicting with procedures the auditor may otherwise be required to perform pursuant to national requirements?*

We agree with including securities offering documents within the scope of the ISA if they meet the criteria in paragraph 9(c) – in essence where they include the documents containing the initial release of the audited financial statements and the auditor's report thereon.

Objectives

5. *Do respondents consider that the objectives of the proposed ISA are appropriate and clear? In particular:*
 - (a) *Do respondents believe that the phrase “in light of the auditor’s understanding of the entity and its environment acquired during the audit” is understandable for the auditor? In particular, do the requirements and guidance in the proposed ISA help the auditor to understand what it means to read and consider in light of the auditor’s understanding of the entity and its environment acquired during the course of the audit?*
 - (b) *Do respondents believe it is clear that the auditor’s responsibilities include reading and considering the other information for consistency with the audited financial statements?*

We consider that the objectives are appropriate. However, further guidance is needed to clarify (1) who is “the auditor” for the purpose of the ISA, and (2) what is the intended scope of “the auditor’s understanding of the entity and its environment acquired during the audit”.

Clarification of who is the auditor is particularly important to identify who is required to “read and consider the other information”. Under the IAASB’s Glossary of Terms “auditor” is used to refer to the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. It is important for the purpose of this ISA to clarify that the auditor is not “the firm” and the auditor is not required necessarily to have knowledge of matters identified in other engagements performed by the firm. In our view, this is not sufficiently clear from the guidance in paragraph A32 which states that “In meeting the requirements of this ISA, the auditor is not required to seek to enhance the auditor’s understanding of the entity and its environment beyond that required for the purposes of the audit.”

However, it is also important that those persons who are assigned responsibility for reading and considering the other information should take into account, where relevant, all knowledge within their own understanding, howsoever acquired, and not ignore knowledge that may have been obtained outside the performance of the audit (e.g. knowledge acquired in previous audits or in other engagements in connection with the audited entity or obtained from other parties not directly associated with the audit). We recommend that this is clarified in paragraph A31 of the ISA by adding guidance to the effect that the auditor’s understanding of the entity and its environment acquired during the audit includes the collective understanding of the engagement team acquired in the course of the current audit, including information acquired and recorded in the audit documentation available to the engagement team in relation to current or prior period audits, and any other information that the audit partner and other members of the engagement team assigned to read and consider the other information may have acquired personally in the course of any other engagements in connection with the audited entity or otherwise.

Paragraphs A33 and A34 of the proposed ISA indicate factors that the engagement partner may take into account when determining the appropriate individuals to read and consider the other information. We agree with those factors but in practice would expect that the engagement partner will read all the other information in addition to assigning specific areas to other appropriate individuals for closer consideration where appropriate. We recommend that this is made clear in the application material. In our current UK and Ireland version of ISA 720, we have supplementary application material which states that “The audit engagement partner (and, where appropriate, other senior members of the engagement team who can reasonably be expected to be aware of the more important matters arising during the audit and to have a general understanding of the entity’s affairs), reads the other

information with a view to identifying significant misstatements therein or matters which are inconsistent with the financial statements or the knowledge acquired by the auditor in the course of performing the audit.”

We understand that it may be argued that it is unnecessary or unduly burdensome for the audit partner to read all the other information in certain circumstances, for example where certain elements of the text are repeated from earlier years or are repeated in the other information associated with more than one set of audited financial statements (for example, those of a number of subsidiaries of the same parent entity). We believe that the expectation that the engagement partner read all the other information could be met in those circumstances by the engagement partner reading one version of the text and having another member of the engagement team read the other versions, identifying and bringing to the engagement partner’s attention any differences from the version read by the engagement partner.

Definition of an inconsistency in the other information

6. *Do respondents agree that the definitions of terms of “inconsistency” including the concept of omissions and a material inconsistency in the other information are appropriate?*

We note that the definition in ED ISA 720R is of an ‘inconsistency in the other information’ and the definition goes on to explain what would make such an item material. When the epithet ‘material’ is applied to the definition, we believe it is designed to encapsulate the concept of something in the other information that is materially incorrect or inappropriate. This is analogous to the concept of a ‘material misstatement in the financial statements’. It encompasses not only items that are factually incorrect but also other items that are judged to be inappropriate (because they are unreasonable or inappropriate or their presentation obscures the reader’s understanding of the matter being addressed). The equivalent concept in extant ISA 720 is the more narrowly defined material ‘misstatement of fact’ (something in the other information that is not related to information in the financial statements and that is materially ‘incorrectly stated or presented’)

We understand that the IAASB considered a number of different possible terms to define the new broader concept but that, in each case, there were natural, legal or regulatory connotations of the terms that led to them being considered unsuitable.

Unfortunately, the term ‘inconsistency in the other information’ (and in particular the use of the word ‘inconsistency’ therein) also has certain connotations which will lead some to question whether it is an appropriate term to use in defining this concept.

We start from the point of view that we agree that the new broader concept (including when such an item would be material) is in itself appropriate. We also believe that the term adopted for its definition is workable. However, we are aware of two issues of connotation that may give rise to some challenges as to the wisdom of using the proposed definitional term for the concept and we comment on these as follows:

- As discussed in our response to Question 7 below, the term ‘inconsistency’ is usually understood to indicate a conflict or apparent contradiction between two items. The proposed definition of an ‘inconsistency in the other information’ does indicate that one of these two items is something in the other information but it does not identify the other item that it conflicts with. We believe that the other item that it conflicts with is the auditor’s understanding of the entity and its environment and that the definition could be improved by stating this overtly, for example as follows:

“Inconsistency in the other information – An inconsistency in the other information exists when it contradicts the auditor’s understanding of the entity and its environment acquired during the audit, and the other information:

- (i) Contains information that is incorrect, unreasonable or inappropriate; or
- (ii) Is presented in a way that omits or obscures information that is necessary to properly understand the matter being addressed in the other information....”

This would follow a similar formula to that adopted in the definition of an ‘inconsistency’ in extant ISA 720, which states that it is ‘other information that contradicts information contained in the audited financial statements’.

- Another possible connotation of the term ‘inconsistency’ that may cause difficulty in interpretation for some is that it may imply to them that there is only an apparent conflict or contradiction between the two items ie that the conflict or contradiction has not yet been resolved to determine whether either or both of the items is ‘wrong’. This is not the intended connotation in the definition in ED ISA 720R as is evident from the objective in paragraph 4: *‘The objectives of the auditor ... are to ... respond appropriately when ... the auditor identifies that ... there **may be** a material inconsistency in the other information ...’* [emphasis added]. Rather, the connotation adopted is that, in relation something that meets the definition, the apparent conflict or contradiction has been resolved and the other information has been judged to be incorrect or inappropriate in accordance with the definition. We believe that ED ISA 720R consistently uses the defined term with this connotation throughout the standard but we acknowledge that some may nonetheless find this confusing.

If so there are in theory three ways to resolve this. Firstly, we believe that any potential confusion could be addressed by clear explanation of the intended connotation in the application material to the definition. In practice, if adequately explained, we believe auditors would be able to understand and apply the concept that the term encapsulates. Secondly, if an alternative term (that does not include the word ‘inconsistency’) can be identified this would avoid the underlying concern and we would support this. However, given the efforts to date to identify an alternative term, this may not be feasible. We do not believe the third alternative – amending the intended connotation, and the definition, to be an apparent contradiction that has not been resolved – would be appropriate, as this would require a fundamental rewrite of the text. Whilst we can see that such a rewrite would be possible, we believe the resulting standard would be more complex because there would be no defined term for something judged to be ‘wrong’ in the other information.

We are also aware that some may question whether the term ‘inconsistency in the other information’ should encompass not only items that are factually incorrect but also other items that are judged to be inappropriate (because they are unreasonable or inappropriate or their presentation obscures the reader’s understanding of the matter being addressed). Whilst information that is factually incorrect is, under extant ISA 720, defined separately as a ‘misstatement of fact’, the extant ISA does not address other items in the other information that are judged to be inappropriate, at all. We strongly support this enhancement in ED ISA 720R to address such matters.

We believe that a single broader term better encapsulates the types of items that the auditor should be seeking to identify as a result of reading and considering the other information in light of their understanding of the entity and its environment acquired during the audit. We

do not support either of the obvious alternatives. Using two separate terms (ie retaining the term 'misstatement of fact' and introducing an additional term for other items judged to be inappropriate) would imply that these items should be treated differently whereas using the term 'material misstatements of fact' as the definitional term for the broader concept would be misleading as it appears to conflict with the underlying concept by referring narrowly to matters of 'fact'.

7. *Do respondents believe that users of auditors' reports will understand that an inconsistency relates to an inaccuracy in the other information as described in (a) and (b) of the definition, based on reading and considering the other information in light of the auditor's understanding of the entity and its environment acquired during the course of the audit?*

No, as discussed in our response to question 6 above, a more common understanding of the meaning of an inconsistency would be something that is not in agreement with something else. The proposed wording for inclusion in the auditor's report does not make clear what the 'something else' is and it is likely that some users will not understand that it means inconsistency with the auditor's understanding that may include inappropriate content in, or presentation of, the other information. It is important to recognise that many users will not have detailed knowledge of the ISA and of the technical terms used in it. See our response to question 11 for suggested improved wording of the statement to be included in the auditor's report.

Nature and extent of work effort

8. *Do respondents agree with the approach taken in the proposed ISA regarding the nature and extent of the auditor's work with respect to the other information? In particular:*
- (a) *Do respondents believe the principles-based approach for determining the extent of work the auditor is expected to undertake when reading and considering the other information is appropriate?*
 - (b) *Do respondents believe the categories of other information in paragraph A37 and the guidance for the nature and extent of the work effort for each category are appropriate?*
 - (c) *Do respondents agree that the work effort is at the expected level and does not extend the scope of the audit beyond that necessary for the auditor to express an opinion on the financial statements?*

We agree with the approach taken in the proposed ISA regarding the nature and extent of the auditor's work with respect to the other information, in particular that the requirements should be principles based.

We believe the categories of other information and the related guidance on the work effort are appropriate and do not extend the scope of the audit beyond that necessary for the auditor to express an opinion on the financial statements. It is clear that the work effort is based on consideration of matters in light of the auditor's understanding acquired for the purpose of the audit of the financial statements and does not require the performance of procedures to obtain further independent evidence, except where the information appears to be inconsistent with their understanding.

We expect that the proposed ISA will cause some auditors to undertake more work on consideration of the other information than currently but, as indicated in our response to

question 1, we believe the associated costs of the proposed changes should not be significant compared to total audit costs.

9. *Do respondents believe that the examples of qualitative and quantitative information included in the Appendix in the proposed ISA are helpful?*

Auditors should be capable of distinguishing between qualitative and quantitative information without this guidance. Therefore we do not believe the appendix is necessary and recommend that it is deleted.

Responding when the auditor identifies that the audited financial statements may be materially misstated

10. *Do respondents believe it is clear in the proposed requirements what the auditor's response should be if the auditor discovers that the auditor's prior understanding of the entity and its environment acquired during the audit was incorrect or incomplete?*

Paragraph 15 makes it clear that if the auditor identifies information that indicates that the audited financial statements may be materially misstated the auditor shall perform procedures to determine whether they are so misstated. However, it is not clear from the requirements and the associated application material that this should include evaluating misstatements identified and seeking to get them corrected by management or those charged with governance before making the final determination. The qualifier in the requirement that the procedures to be performed in determining whether the financial statements are materially misstated are those "necessary under the ISAs" may be meant to address this but, if so, that is not necessarily clear. Improvements to the application material could help clarify this, as explained below.

The application material in paragraph A49 identifies only that the procedures performed may provide information that has implications for the auditor's understanding of the entity and its environment and accordingly its risk assessment (and gives a cross reference to paragraph 31 of ISA 315 which relates to this circumstance). It may be helpful to expand the guidance to indicate also that if the auditor determines before the date of the auditor's report that there are misstatements in the financial statements the auditor accumulates them with other misstatements identified in the audit for evaluation in accordance with the requirements of ISA 450. Reference could also be made to paragraph 10 of ISA 300 which requires that "The auditor shall update the overall audit strategy and the audit plan if necessary during the course of the audit" – the associated application material indicates this may be necessary as a result of unexpected events changes in conditions or the audit evidence obtained from audit procedures.

Reporting

11. *With respect to reporting:*
- (a) *Do respondents believe that the terminology (in particular, "read and consider," "in light of our understanding of the entity and its environment acquired during our audit," and "material inconsistencies") used in the statement to be included in the auditor's report under the proposed ISA is clear and understandable for users of the auditor's report?*
 - (b) *Do respondents believe it is clear that the conclusion that states "no audit opinion or review conclusion" properly conveys that there is no assurance being expressed with respect to the other information?*

We have some concerns that the wording of the statement to be included in the auditor's report in accordance with paragraph 16 and illustrated in paragraph A57 may not be clear


and understandable for all users of the auditor's report. This is primarily because, although accurate, the proposed terminology is probably too technical for the average reader to comprehend easily. In particular, it may not be clear that an inconsistency is determined solely by reference to the auditor's understanding of the entity and its environment acquired during the audit. We also believe that the use of the terms 'review' and 'review conclusion' in the auditor's report may not be understood. Notwithstanding the inclusion of the required caveat, users may well not understand clearly the derivative nature of the assurance being provided. We suggest the following alternative reporting format:

"As part of our audit, it is our responsibility to compare the information in [.....] ("Other Information") with our understanding of the entity and its environment acquired during our audit of the financial statements and to report any material inconsistencies with this understanding that we have identified in the other information. We are not required to audit the Other Information or to perform other verification procedures on information to the extent that it is outside our understanding of the entity and its environment. We report that we have not identified material inconsistencies in the Other Information on this basis."

12. *Do respondents believe that the level of assurance being provided with respect to other information is appropriate? If not, what type of engagement would provide such assurance?*

We believe it is appropriate that the ISA does not require 'reasonable assurance' to be provided with respect to the other information. Whether the scope of the audit should be extended or a separate assurance engagement undertaken, for the other information is a matter that should be determined by national laws and regulations.

Yours sincerely



Nick Land

Director of the FRC and Chairman of the FRC's Audit & Assurance Council

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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.