The experience of the adoption of the New Audit Report in the UK

James Ferris
Project Director, Audit Policy

FRC

Overview

Financial Reporting

- 2012 UK Corporate Governance reforms
- Build public trust in financial reporting

Audit

- Make audit more transparent
- Underpin quality
- Build public trust in audit

Experience

- UK experience positive
- Investors welcome new audit reports
- Only the beginning of engagement process

The Value of Audit

Public trust in corporate governance and reporting <u>depends on</u> public trust in audit

Challenges:

- Lack of transparency about audits
- Audited entity appoints and pays the auditor

Corporate Governance Reform

- In 2012 the FRC made co-ordinated changes to Auditing Standards and to the UK Corporate Governance Code
- Partly in response to the 2008 financial crisis
- Enhanced role of directors and audit committees in financial reporting
- Introduced a new form of auditor’s report

Who produces extended auditor reports in the UK?

- Auditors of companies with a premium UK listing, and those who voluntarily adopt our Corporate Governance Code
- From 2016 this will cover all listed entities, public interest entities and those who voluntarily comply

Highlights of experience to date

- FRC reports on first two years of new auditor reporting in the UK
- Engaged with investors, auditors and others
- Auditors have innovated significantly.
- Auditor reports now provide significantly more and better information
- Response from investors enthusiastic, including annual ‘awards’ for the best reports

Highlights of experience to date

- Investors, firms and audited entities broadly in favour of extended auditor reporting
- Language continues to move away from generic to specific
- The ‘best’ reports are well structured and consider needs of user
- Some reports include ‘findings’
- Investors want more granularity about ranges in management estimates and results of audit testing
- However little analysis of change in issues between first and second years

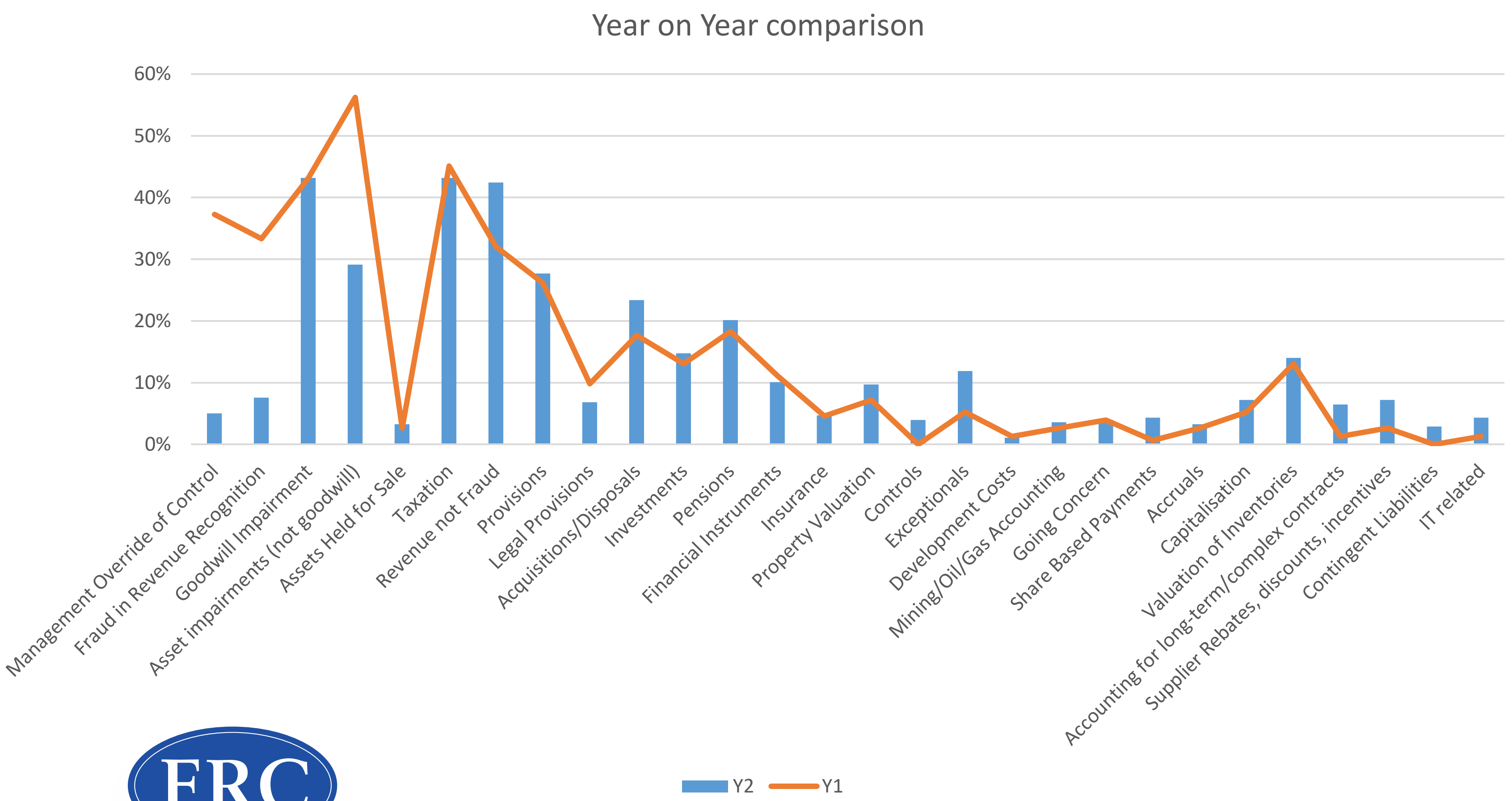
Key audit matters

- FRC required auditors to:
  - Describe risks of material misstatement with greatest effect on the audit
  - Greatest effect on the audit strategy, allocation of resources and directing efforts of the team
  - Complement the description of significant issues by the Audit Committee/Those Charged With Governance

Key audit matters

- Tax, Impairments (goodwill and others), Revenue, Provisions, Acquisitions/Disposals and Pensions most frequently reported risks
- In the second year of reporting we saw a move away from inclusion of generic risks of material misstatement (management override and fraud in revenue recognition)

Key audit matters



Key audit matters

- Language used to describe risks became less generic
- Challenge to be even more precise – avoid “significant downward adjustments”, “mildly cautious” etc.
- Only 20% of auditor reports included findings (vs. 2% in year 1)

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Key audit matters

- Auditors generally did not explain changes year-on-year

Content of Reports	No. including the content	% of sampled reports
Audits with an overview of changes section	2	2%
Audits which explain changed materiality or benchmark	16	15%
Audits which provide commentary on changes to scope since prior year	2	2%
Audits which explain changes to areas of audit focus since prior year	24	22%

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Key audit matters

- Those reports which won The Investment Association Prizes included a description of changes
- Investors told us they welcomed explanations of changes in risk profile

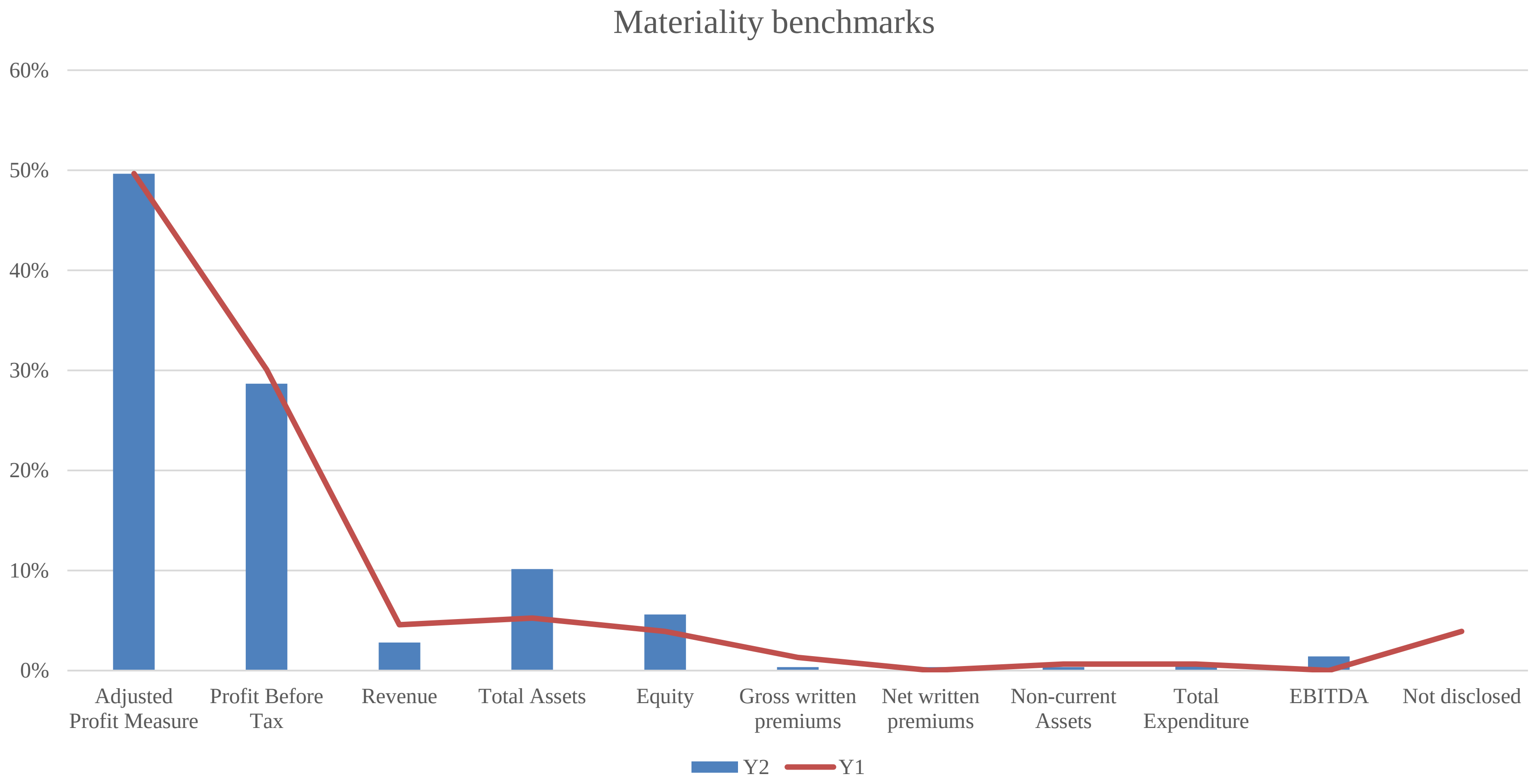
Materiality

- The FRC standards go beyond the requirements of both the IAASB and PCAOB proposals
- FRC requires auditors to:
  - Explain how they applied the concept of materiality in both planning and performing the audit
  - Disclose the materiality threshold for the audit of the financial statements as a whole

Materiality

- Investors would like more explanation about the reasons for the benchmark chosen, and the % applied
- Investors are sceptical about a methodology which “nearly always ends up at 5% of profit”
- Only one firm discloses performance materiality.

Materiality



Scope

- FRC required:
  - Broad description of how the audit covered measures such as proportion of profit, total assets and revenue
  - How the significant issues and risks impacted what was done
  - The relationship between scope, risk and materiality

Scope

- Investors told us more could still be done:
  - more information on the differentiation between full scope and other procedures
  - commentary on quality control over international group audits

Lessons Learned

- Auditor's reports are becoming more interesting to read
- Reports are increasingly well structured, user friendly and fluent representations of the audit process
- No evidence that the reporting timetable has been disrupted
- No evidence of related increase in audit fees

Lessons Learned

- Prescription does not deliver innovation – the market will respond
- Audit reports can stimulate engagement but are the beginning of the process
- Transparency helps drive up audit quality which builds confidence
- Confidence can easily be lost if the quality of the work does not reflect the quality of the audit report