Report

Financial Reporting Council

January 2016

Extended auditor's reports

A further review of experience

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Extended auditor's reports: A further review of experience

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Executive Summary

Audit firms innovated significantly in the first year of extended auditor's reports. These innovations have been retained and in some areas enhanced in the second year, although the pace of innovation has unsurprisingly slowed in the second year; a period of consolidation and improvement.

We welcome the continuing development of good quality auditor reporting and support the trend towards more granular (but still concise) descriptions of risk, the more transparent and accessible reporting of audit findings, and the disclosure of materiality.

Our review of the second year of extended auditor's reports has been expanded to cover 278 reports (compared to 153 in year one) or nearly 80% (44% in year one) of the UK's largest companies from the main UK listed market. We have also engaged directly with investors, including a round table discussion, reviewed relevant publications, academic analysis and had discussions with the major audit firms.

The key findings from our review this year include:

- Investors have welcomed extended auditor reporting, and greatly value the enhanced information it provides. The value added can be particularly important for those audited entities where there are fewer sources of other information, including smaller companies;
- The reports which have earned the greatest praise from investors this year are carefully structured with the end user in mind, and signpost key information. They also include clear, concise and transparent disclosures about risk, scope and materiality, as well as the critical areas where professional judgement and assumptions have been addressed;
- The language used in auditor's reports continues to evolve, and we have noted a further welcome move away from generic risk descriptions and language generally, in favour of more granular descriptions;
- Investors feel that more could still be done to enhance auditor's reports, including: providing more complete information about the sensitivity ranges used in testing; the auditor's assessment of the quality of an entity's internal controls informing their significant risk assessment; and the auditor's view on the appropriateness of management estimates. Investors would prefer greater transparency about assumptions made by management and benchmarks used by auditors. However this has to be balanced against the potentially competing demands of clarity and conciseness, as well as preserving the importance of reading an overall true and fair opinion;
- One disappointing aspect of reporting this year from the perspective of many investors we have spoken to is the widespread absence of explanations by auditors of changes in their audit approach, in the level of materiality they used or in the assessed risks reported from one year to the next. Although we have found some examples where this type of material is included, it is very much the exception. Auditor's reports therefore generally lack a dynamic analysis of changes over time;

- In 2014 a small number of audit reports included the auditor's findings for risks of material misstatement. This is not a mandatory requirement, but was broadly welcomed by the investor community. The number of such reports has increased in the second year of reporting, but not to the extent that might have been expected given the favourable prior year response by users of annual reports and accounts. Our discussions with audit firms suggests that the primary reason for this has been a lack of demand from the audited entities themselves;

- There continues to be a close alignment between Audit Committee reporting and auditor's reports;

- Materiality still presents an area of challenge, despite the innovative approaches adopted in year one. There is still only limited commentary by auditors on the reasons for using or changing particular materiality benchmarks, or on the reasons for significant changes in the overall level of materiality used for the financial statements as a whole. The investors we have spoken to would welcome more commentary in this area; and

- "Performance Materiality" – Very few audit firms disclose information about their use of this metric. The fact that so few auditors (only one audit firm does this routinely) attempt to explain and describe performance materiality, and how it relates to their assessment of the quality of internal controls in audited entities, makes it impossible to make meaningful comparisons in this area between auditors, sectors and audited entities. Many investors have expressed a strong preference for enhanced disclosure on all aspects of materiality and how it impacts on the conduct of the audit. Many of the audit firms we spoke to believe that performance materiality is a particularly difficult and technical aspect of materiality to explain, and question the value of further disclosure.

- We are currently reviewing changes to UK and Ireland auditing standards as part of the implementation of the reforms arising from the EU Audit Regulation and Directive. These changes will include revisions made to international standards on auditing, although we will retain the UK's extended auditor reporting requirements. The effective date for these revisions in the UK will be 17 June 2016. Internationally, changes to standards will be for periods ending on or after December 15, 2016. This means that there will continue to be significant interest in the innovation and transparency that we have seen to date in the UK and how this drives further enhancements to auditor's reports.

Section 1: Introduction

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In 2012, the Financial Reporting Council made co-ordinated changes to Auditing Standards and to the UK Corporate Governance Code. These changes set the requirement for boards to ensure that the annual report of a company should present a **fair, balanced and understandable assessment of the company's position and prospects**, and for Audit Committees to formally report on their activities in Annual Reports.

Changes made to the Auditing Standards set three high level requirements for the auditor's report to provide an overview of:

- Those risks of material misstatement that were identified by the auditor, and which had the greatest impact on the audit strategy, resources required and the work of the engagement team;
- The application of materiality; and
- The scope of the audit, including how it responded to the risks of material misstatement and the application of materiality.

These reporting requirements were deliberately set at a high level with the view of encouraging auditors to innovate in their approach to reporting, and in so doing making available to investors and other users of the financial statements the auditor's insight and understanding of the entity they are auditing, based on the work that they have done.

These developments were, in part, a response to the post 2008 financial crisis and the need to enhance confidence in financial reporting and audit. In order to help achieve these objectives there was a need for auditors to move to an enhanced reporting regime, and provide better and more contextual information about the approaches they had adopted and the judgements they had made. This was a move away from boilerplate reporting with a binary opinion, recognising the significance of the exercise of professional judgement in coming to a view on the truth and fairness of financial statements.

In March 2015, we reported on the way in which auditors responded to the new requirements. This showed the existence of considerable innovation, and therefore, diversity in the way in which auditors had addressed the requirements. We were also able to provide an overview of the response from the investor community. Investors clearly valued the additional insight offered by extended auditor reporting, and have since encouraged the adoption of greater transparency, particularly in respect of auditor's judgements and their findings.

This is our second published review of the experience of extended auditor reporting, and is intended to highlight new trends, innovations and good practice and to highlight how extended auditor's report have continued to develop.

The changes made have placed the UK at the forefront of international reforms and auditor reporting. There is significant stakeholder interest in the impact of extended auditor reporting in the UK ahead of the introduction of revised auditor reporting standards by the International Auditing and Assurance Standards Board (IAASB), and from other significant capital markets. The revised

IAASB standards introduce changes to auditor reporting which are broadly consistent with the existing auditor requirements in the UK.[1] Only a very small number of countries have implemented similar reforms, including the Netherlands and Australia, whilst others are considering unpublished 'dry run' extended auditor reporting in anticipation of the revised standards coming into force.

The IAASB's revised auditor reporting standards include International Standards on Auditing (ISAs) 700: Forming an Opinion and Reporting on Financial Statements and 701: Communicating Key Audit Matters in the Independent Auditor's Report. All audits of financial statements of listed entities conducted in compliance with these standards, "and circumstances when the auditor otherwise decides" will be required to communicate "key audit matters" in the auditor's report. Key Audit Matters are broadly equivalent to the "assessed risks of material misstatement" included in the current version of ISA (UK and Ireland) 700 The Independent Auditor's Report on Financial Statements. Revisions to UK and Ireland standards are also required to implement changes to EU regulation, including for statutory audits of financial statements of public-interest entities, the requirement to include:

a) A description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud;

b) A summary of the auditor's response to those risks; and

c) Where relevant, key observations arising with respect to those risks.[2]

Several of the audit firms have published an assessment of the initial period, and have signposted areas for potential further improvement. PwC, for example, specifically identified a greater focus on describing and highlighting changes over time as an area of future focus.[3]

It is against this wider context that we have completed a more extensive review of the second year of published reports, covering nearly 80% of the largest listed companies (FTSE 350) in the UK. Once again we have looked at each of the key elements of the auditor's report and attempted both quantitative and qualitative analysis. This review has been supplemented by discussions with those audit firms carrying out the audits of those entities and with investors. We have also benefitted for the second time from the insights provided by The Investment Association Auditor Reporting awards. In addition, we also had access to a similar review of FTSE 100 auditor's reports by Citi Research. The findings of that report – and particularly those issues of most interest to investors and analysts – are broadly consistent with our own.

1 https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit.aspx
2 Proposed International Standard on Auditing (UK and Ireland) 701, Communicating Key Audit Matters in the Independent Auditor's Report, https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Consultation-Auditing-and-ethical-standards-implem.aspx
3 PwC, The revolution in audit reports, August 2015, p.10. See also, for example KPMG, Audit committees' and auditors' reports, May 2014.

Impact of Auditor Reporting

The changes to the UK corporate reporting and auditing regime which led to the introduction of extended auditor reports was intended to provide users of financial statements with greater confidence in the integrity and reliability of financial reporting, and in the audit process. Investors and audit firms have told us that one impact from the existence of this additional information has been the beginning of more regular dialogue between auditors, investors and audit committees. Enhanced corporate reporting through Audit Committee reports has allowed more effective triangulation, by investors, of evidence contained in those views presented by management, non-executives and the independent auditor. Investors told us that they are still learning to decode and evaluate the language used by auditors in their reports, and it is likely that as they do so there will be more opportunities for better dialogue and engagement between them.

In addition, there is growing interest in the impact of this UK initiative from other regulators in other jurisdictions who are considering whether to implement similar reforms. There is also emerging academic interest in identifying evidence of impacts. Most recently, a study looked at patterns of trading activity in the period just after the combined introduction of Audit Committee reporting and extended auditor's reports. The analysis strongly suggests that the publication of these reports did have an observable impact on the volume of trading activity – and therefore by implication that they are being actively used as part of the investor decision making process:

> *We find that additional mandated auditor and audit committee disclosures provide investors with new and useful information that impacts their trading decisions. The release of additional useful information not only affects investors, but also has important implications for public companies, regulators, other financial statement users, and the overall capital markets. In addition to commenting on the effect of these changes in the United Kingdom (an important market to examine in isolation), this setting informs the debates occurring globally.*[4]

The evidence they have used suggests that the relative impact is greater for companies where there is limited additional information, and that these reports are therefore addressing an information deficit:

> *…companies with a high analyst following do not experience a significant increase in abnormal trading volume around the implementation of the auditor and audit committee report revisions…. we find that companies with a low analyst coverage are associated with a significant increase in abnormal trading volume….In other words, as the information environment weakens (i.e. analyst following decreases) there is a greater increase in the usefulness of the reports as a result of the additional auditor and audit committee disclosures…*[5]

In a related study, the same authors looked for indications that these new reports had had an impact on audit quality, or on the level of audit fees. On quality, they focussed on two 'proxy'

4 Reid, Carcello, Li, Neal, Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom, July 2015, p.7
5 Reid, Carcello, Li & Neal, Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom, July 2015, p.25

measures – the level of 'absolute abnormal accruals'[6] and the propensity of audited entities to either just meet or beat analyst forecasts. Any reduction in the level of these metrics is seen to indicate a reduction in management's 'opportunistic earnings management'. These are potentially linked to the introduction of extended auditor and audit committee reporting because:

- Transparency increases the accountability of auditors and audit committees to users of financial statements;
- An enhanced focus by auditors and audit committees on the most significant areas in the financial reporting process;
- Auditors gain more 'leverage' over management because they gain the ability to include more detail in their reports.

The authors conclude that:

> *Using a balanced sample of firms, we find that the UK's new reporting regime is associated with an improvement in audit quality. Specifically, we document significant decreases in abnormal accruals and the propensity to just meet or beat analyst forecasts.…while we find some limited evidence that audit fees increased after the reporting changes, the increase.… is not significantly different from the audit fee change documented in the prior year..[and is therefore]..likely unrelated to the new reporting requirements.*[7]

This analysis, albeit some of it looking at short term trading metrics, suggests that the information included in both Auditor's Reports and Audit Committee reports has value, and may be directly influencing the behaviour of management and thereby increasing the confidence of investors in audited entities. Of course, many investors also have a longer term view, and are interested in stewardship information – including how effectively entities are controlled, how they are managing their risks, assets and liabilities – and these reports are a new source of complementary information and insight. Over time we will seek to understand the longer term implications of reporting.

Our Report

Our report draws on the evidence of our sample to consider the key aspects of extended auditor's reports, principally the reporting of audit risks, of materiality considerations and of the audit scope. In doing so, we also draw out the necessary interactions between these elements. We also consider some additional aspects of this enhanced reporting, including the relationship between auditor's reports and those of audit committees, as well as what auditors say about the going concern basis of accounting and longer term viability statements.

In conducting this work we have actively engagement with the investor community, and our report concludes with a summary of the feedback we have received and of the results of The Investment Association Auditor Reporting awards.

6 This is the absolute value of accruals which are deemed to be outside the 'normal' expectation for an entity, and which may be suggestive of earnings management.
7 Reid, Carcello, Li & Neal, Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom, August 2015, p.28

Section 2: Extent of the survey

In the course of writing this report we drew on many sources of information, but the principal source of evidence was a review of published auditor's reports. We extended our sample of auditor's reports from 153 last year to 278. These reports were drawn from the top 350 companies listed on the UK's Main Market, plus those of the Institute of Chartered Accountants in England & Wales (ICAEW) and the Financial Reporting Council (FRC).

These reports gave us coverage of nearly 80% of all auditor reports produced in the second year that the provisions for extended auditor's reports have applied to companies listed on the Main Market, and significantly expanded the scope of our analysis. As in the previous review our approach to sampling was random, although we were concerned to ensure adequate coverage of a wide range of industry sectors. In addition to the main sample, we also looked at a small number of additional reports where these allowed us to follow up on particular issues or areas of interest. One example is in the review we did of the audit reports of entities who were 'early adopters' of Viability Statements under the Governance Code.

Table 1: auditor's reports reviewed by audit firm

	FTSE 100 No	FTSE 100 %	FTSE 250 No	FTSE 250 %	Total No	Total %
Deloitte LLP (Deloitte)	18	20%	58	31%	76	27%
EY LLP (EY)	12	13%	28	15%	40	14%
KPMG Audit PLC (KPMG)	22	25%	52	28%	74	27%
PwC LLP (PwC)	36	40%	43	23%	79	28%
BDO LLP (BDO)	1	1%	2	1%	3	1%
Grant Thornton UK LLP (Grant Thornton)	0	0%	5	3%	5	2%
Haysmacintyre LLP (Haysmacintyre)	0	0%	1	1%	1	0%
Total	89	100%	189	100%	278	100%

The survey addresses separately each of the requirements of the auditing standards:

a) Reporting of risks
b) Reporting of materiality; and
c) Description of the scope of the audit.

The report also looks at some specific additional areas of interest including:

a) Impact from change of auditor

b) Going Concern basis of accounting and longer term viability
c) Location of the audit opinion
d) Audit Committee reporting
e) The Investor view

Additional sources of information included:

- Active engagement with members of the investment community, including a round table discussion and other bi-lateral engagement;
- Meetings with the technical teams from each of the major audit firms who were responsible for the central methodology, oversight and review of auditor's reports;
- A review of relevant published information, including analyses of the impact of auditor reporting by PwC and KPMG;
- An analysis of FTSE 100 second year auditor reports produced by Citi Research, which focussed on the investor/analyst perspective;
- Emerging academic research looking at the impact of auditor and audit committee reporting on market participants.

Table 2: auditor's reports reviewed by industry sector

Sector	No. in sample from FTSE 350
Banks & Financial Services	45
Basic Materials	6
Business Services	2
Commercial Properties	21
Construction Services	10
Consumer Goods & Services	56
Health Care	12
Industrials	21
Information Technology	8
Insurance	13
Metals & Mining	12
Natural Resources	1
Oil & Gas	11
Regulator/Professional Body	2
Retail	22
Support Services	24
Telecommunications	6
Utilities	6
All companies	**278**

Section 3: Audit Risks

Our discussions with investors and with the audit firms have confirmed that the disclosure of areas of enhanced audit focus around risks has been the area of keenest interest for investors. It has also, to a limited extent, begun to create a climate where some investors at least have used the insights and information provided to engage more directly with auditors, and also with audit committees. Since, ultimately, the purpose of these reports is to provide investors with assurance about the quality and reliability of financial statements, this is a welcome and positive development.

One of the most powerful aspects of the new extended auditor reporting regime is the inclusion of information on those risks of material misstatement which are considered, by the auditor, to have the greatest impact on the resources deployed and strategy developed for the engagement. This information allows comparative analysis by type of risk, by market capitalisation (e.g. FTSE 100 vs FTSE 250), by market sector and over time. The analytical value of this qualitative data for investors is significantly enhanced when descriptions of risks are clear, understandable, relevant to the specific context of the entity ***and*** concise.

There were some examples of innovation in the presentation of areas where there was a risk of material misstatement. The auditors of National Grid, for example, categorised risks as either 'event-driven' or 'recurring'. [National Grid PLC, PwC Independent Auditor's report, p/e 31 March 2015] The auditors of Marks and Spencer earned praise from The Investment Association Auditor Report awards for the clarity of the organisation and presentation of risks of material misstatement. [Marks and Spencer PLC, Deloitte Independent Auditor's Report, p/e 28 March 2015] The auditor report for BG Group included an additional section setting out what the audit team reported to the audit committee about each risk at the conclusion of the audit. [BG Group, EY Independent Auditor's Report, p/e 31 December 2014] The same firm also won a The Investment Association award for the risk reporting section on the auditor's report for Evraz PLC because of the clear explanation of what had changed since the previous year, and the use of arrows to indicate whether individual risks were of more or less concern in the current year.

Changes from the prior year

Our audit approach and assessment of areas of focus changes in response to changes in circumstances affecting the EVRAZ business and impacting the Group Financial Statements. Since the 2013 audit we have made the following changes to our areas of focus:

- At 31 December 2014 the balance of assets held for sale is no longer significant to the Group. We have therefore removed this as a focus area of our audit.
- The deterioration of the economic situation and continued political unrest in the Group's main area of operation has increased the potential impact of this risk on the Group's business. This has led us to an increased focus on this area.
- The impact of foreign exchange is a new area of focus for the current year in response to the significant devaluation of the Russian Rouble.
- We have also included segmental reporting as a new focus area in response to the restatement of the Group's Financial Statement disclosures resulting from changes in internal management reporting.

Area of focus	Our audit approach and conclusion
Goodwill and non-current asset impairment Refer to the Group Audit Committee Report on page 79, the estimates and judgments on page 131 and the disclosures of impairment in note 6 of the Consolidated Financial Statements	Risk direction:
At 31 December 2014 the carrying value of goodwill was US$1,541 million. The Group recognised impairment charges in respect of goodwill, other intangible assets, items of PP&E and other non-current assets during the year of US$540 million. In accordance with IAS 36 management disclosed that in addition to the impairment charge already recognised, a reasonably possible change in discount rates, sales prices, sales volumes and cost control measures could lead to impairments in other CGUs where no impairment is currently recognised. We focused on this area due to the significance of the carrying value of the assets being assessed, the number and size of recent impairments, the current economic environment in the Group's operating jurisdictions and because the assessment of the recoverable amount of the Group's Cash Generating Units ("CGUs") involves significant judgements about the future results of the business and the discount rates applied to future cash flow forecasts. In particular we focused our effort on those CGU's with the largest carrying values, those for which an impairment had been recognised in the year and those with the lowest headroom.	We performed audit procedures on all impairment models relating to material cash generating units. Our audit procedures were performed mainly by the Group audit team with the exception of certain location specific inputs to management's models which were assessed by the component teams. Our audit procedures included the review of management's assumptions used in their impairment models. The assumptions to which the models were most sensitive and most likely to lead to further impairments were: • Decreases in steel prices; and • Increases in production costs. We challenged management's assumptions with reference to historical data and, where applicable, external benchmarks noting the assumptions used fell within an acceptable range. We tested the integrity of models with the assistance of our own specialists and carried out audit procedures on management's sensitivity calculations. We assessed the historical accuracy of management's budgets and forecasts. We compared current performance with forecasts, and sought appropriate evidence for any anticipated improvements in major assumptions such as production volumes or cost reductions. We corroborated previous forecasts with actual data. We considered the appropriateness of the related disclosures provided in the Group Financial Statements. In particular we considered the completeness of the disclosures regarding those CGUs with material goodwill balances and where a reasonably possible change in certain variables could lead to impairment.

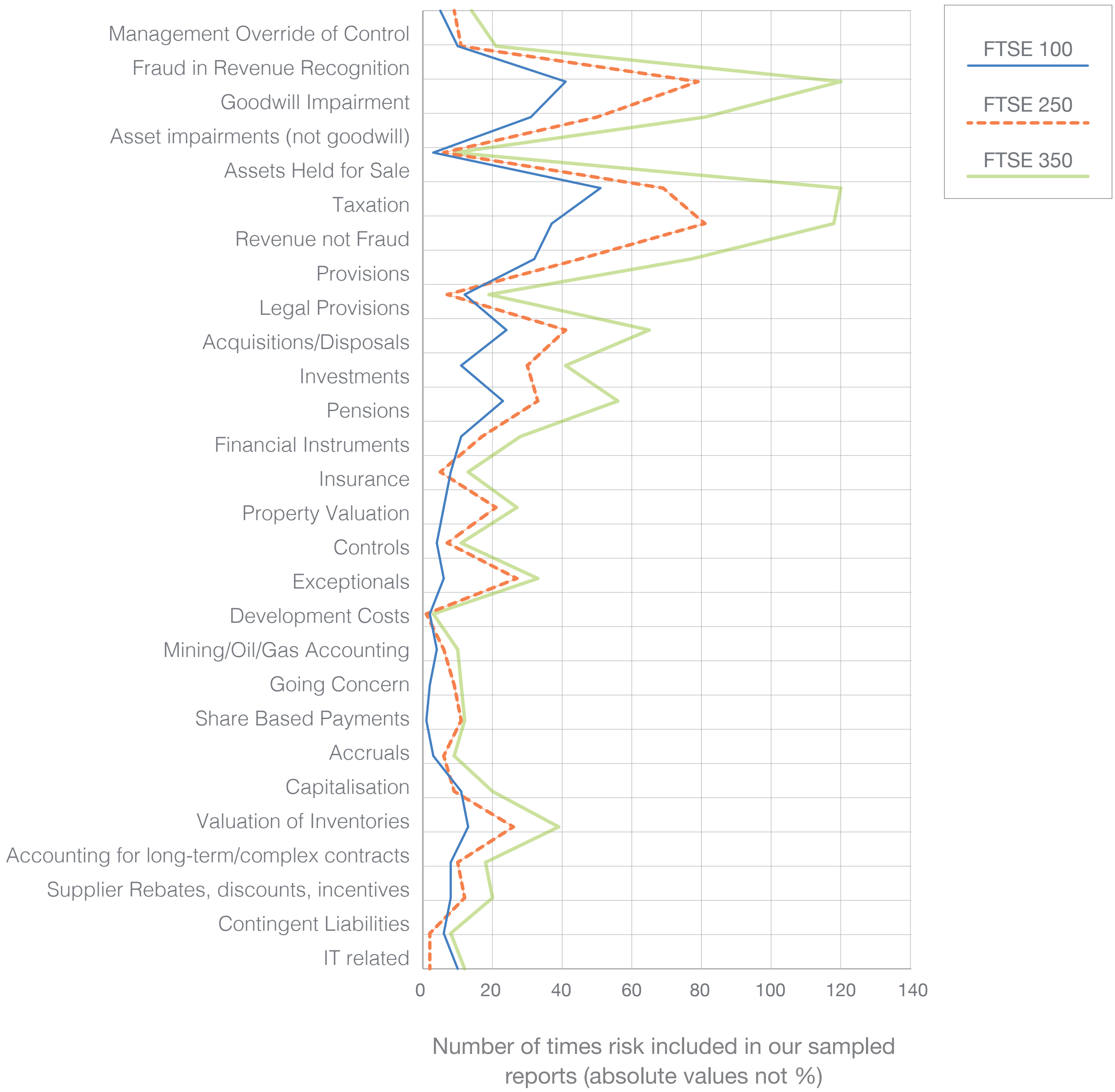
The auditors of Rolls-Royce continued to provide information about findings against each identified risk, and to present these risks and the auditor's response in a transparent and informative way. [Rolls-Royce PLC, KPMG Independent Auditor's Report, p/e 31 December 2014] Similarly the auditors of Intermediate Capital Group provided transparent disclosure of their discussions with management of the valuation of collateralised loan obligations, and were also recognised by The Investment Association. [Intermediate Capital Group PLC, Deloitte Independent Auditor's Report, p/e 31 March 2015]

One clear message from users is that enhancing the quality of one aspect of the auditor's report leads, inevitably, to even higher expectations. So, for example, as the users of financial statements get greater granularity about risks, they expect a similar enhancement to information about how those risks were dealt with by the auditors and what the auditors then found. This will become a much more common expectation after the completion of current revisions to auditing standards as a result of the EU Audit Directive and Regulation. We consider the extent to which auditors have innovated in respect of audit findings later in the report. As part of our review we have collected a large quantity of data on reported risks, which is analysed in the following tables. We have also considered the extent to which this information is consistent with or complementary to issues raised in Audit Committee Reports. [see separate section]

Risk Types

Graph 1 below illustrates the wide range of risks reported, disaggregated between FTSE 100 companies and the next 250 largest listed entities. This represents the total number of each individual risk type within our sample.

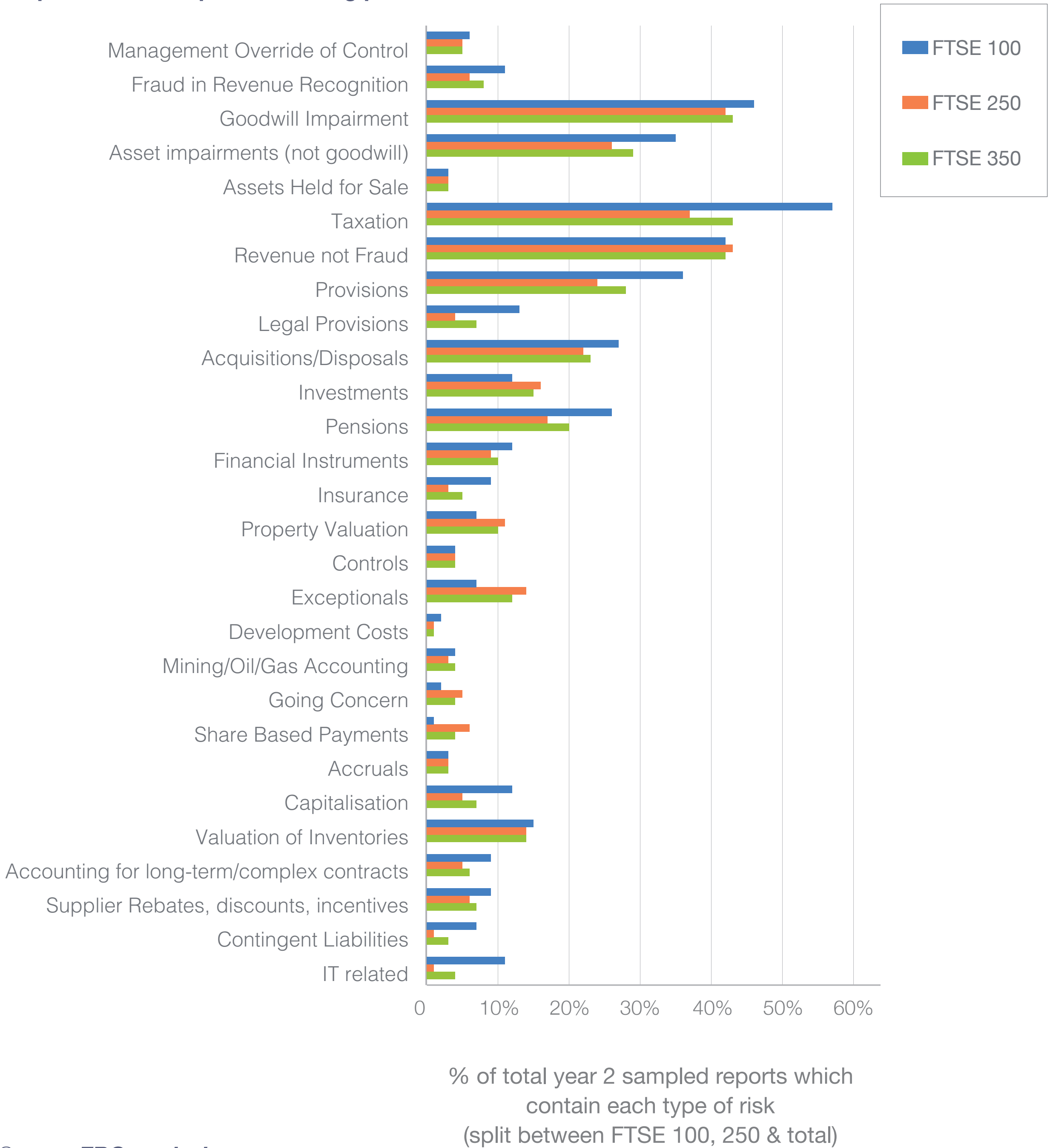
Graph 1: Risk Types in year 2



Source: ***FRC analysis***

Graph 2 below represents this data as a percentage of the total sample we have reviewed. For example we can see that the most common risks across our entire sample are those relating to impairments of goodwill (included in 43% of sampled audit reports), taxation (43%), accounting for revenue (42%) and other asset impairments (29%). Since these are often critical areas of management judgement, and of particular significance to the valuation of companies, this is perhaps unsurprising.

Graph 2: % of sample addressing particular risks



Source: ***FRC analysis***

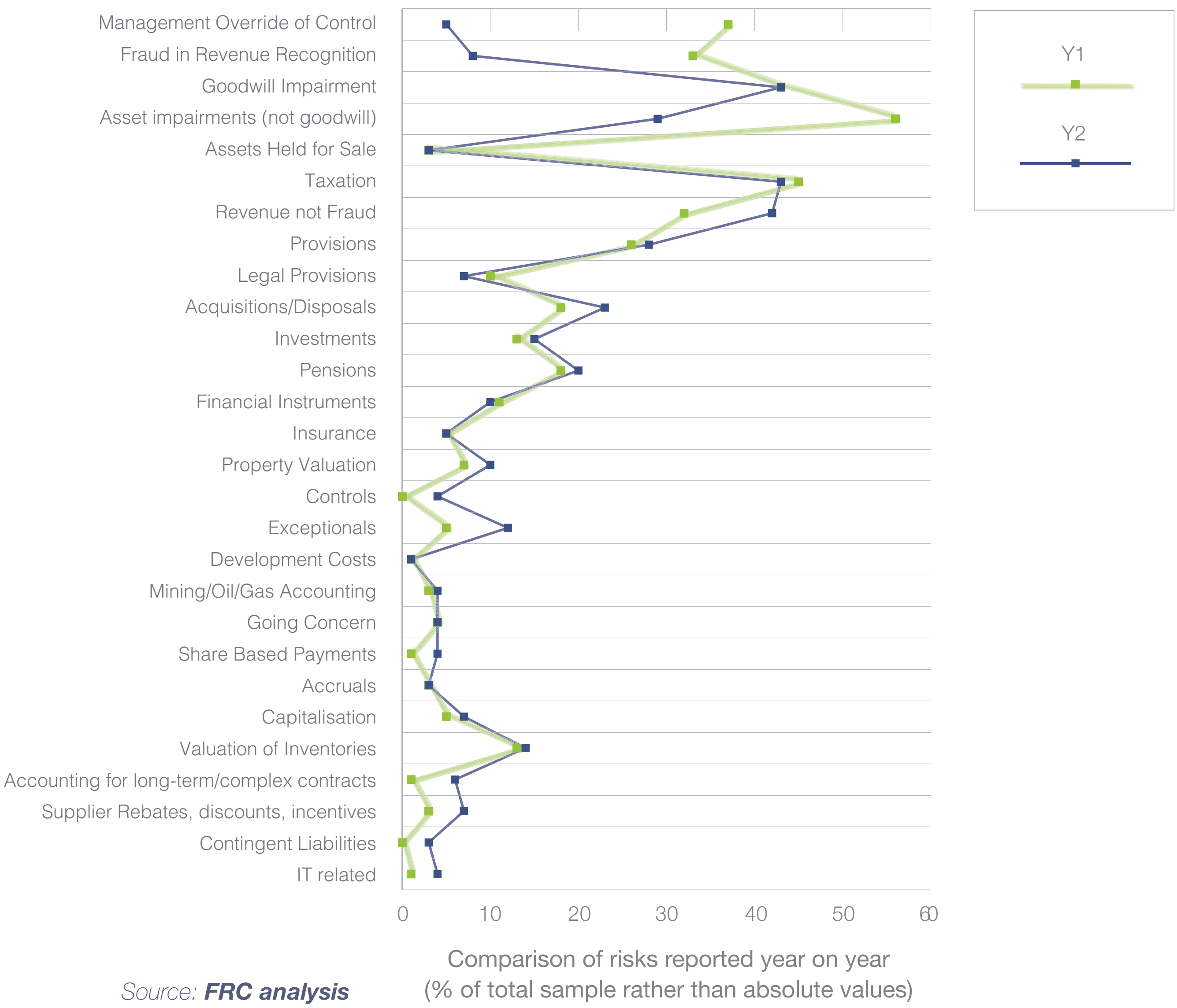
These findings are broadly consistent with year one. A full comparison can be found in graph 3 below which demonstrates:

- A significant fall in the number of reports including the ISA (UK and Ireland) mandated risks of management override of control and fraud in revenue recognition. This is an encouraging trend since the intention of the revised auditing standard was to ensure that auditors disclosed those risks which had greatest impact on their overall audit strategy, approach and resources, and not a complete list of all risks and issues identified in the course of the audit;

- An increase in the proportion of auditors describing audit risks relating to revenue, acquisitions and disposals and exceptional items; and

- A decrease in reported issues around non-goodwill asset impairments.

Graph 3: Year on Year comparison



Source: ***FRC analysis***

Sectoral Analysis

We have also analysed the distribution of risks between different sectors of industry, and the results of our review are set out in the following tables.

The first analysis compares the average number of risks disclosed for companies in each sector, including a year on year comparison. This indicates that, by and large, there has been no significant increase or decrease. Combined with our analysis of the total number of risks being reported across our sample (see further below) this suggests that the audit firms generally believe they have calibrated the number of reported risks correctly.

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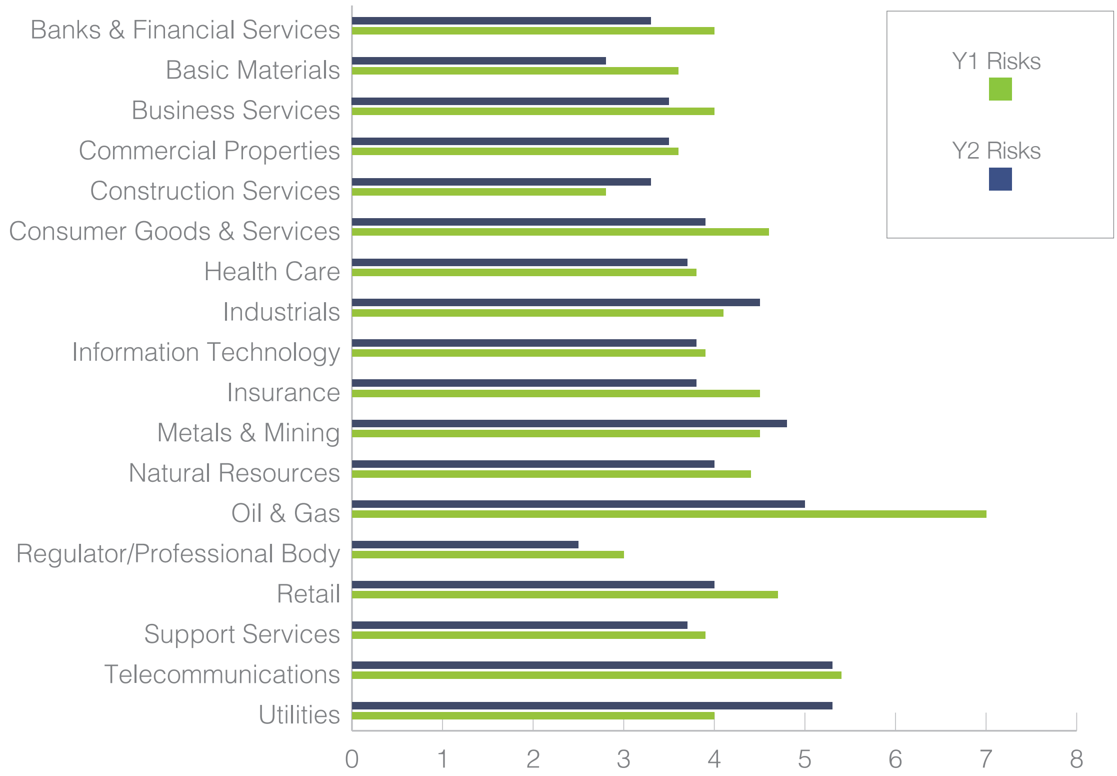
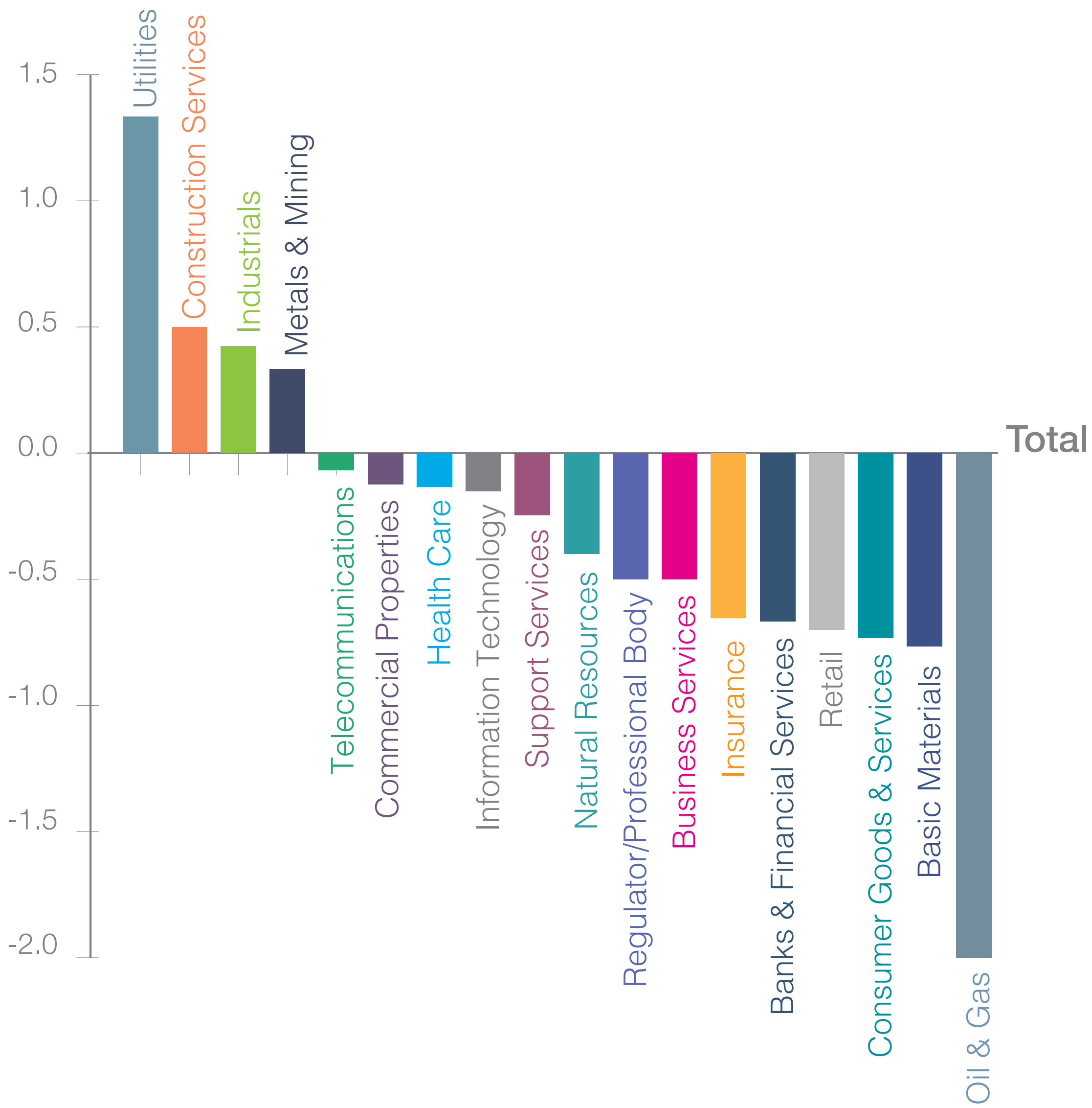
Graph 4: Number of Risks by Sector



Source: ***FRC analysis***

Further analysis of changes in the number of reported risks by sector (see Graph 5 below) shows that on average the number of risks being reported has increased most in the Utilities sector and decreased most in the Oil & Gas sector. This may reflect the fact that last year these sectors were at the opposite ends of the spectrum in terms of the average number of reported risks. It may be that as a result, and having looked at practice elsewhere, the auditors in these sectors are moving closer to expected practice elsewhere. For this information to be truly valuable, however, it must be supplemented by meaningful and insightful commentary at the more granular level. Whilst we have certainly seen evidence that risks are being described at a greater level of granularity, there is still comparatively little information on why the audit risk profile in the audit of a specific entity or of a particular sector may have changed year on year.

Graph 5: Change in the average number of risks reported by sector between year 1 and year 2



Source: ***FRC analysis***

How granular are risk descriptions?

We have also reviewed the risk descriptions themselves, with the aim of assessing whether or not auditors have avoided the use of generic language. Consistent feedback from the users of auditor's reports is that they like descriptions which are specific to the entity being audited – such that it would be possible to identify the entity just from the contextual information provided.

Our review of the granularity of risk reporting is necessarily subjective, however the results indicate that auditors have made significant progress in describing these issues in a way which is more tailored and, therefore, specific to the audited entity, thus avoiding generic or boilerplate wording. The data suggests that a much greater proportion of risks are set out in a more meaningful and transparent way – up to 87% from 61% in year one. This is also consistent with the feedback we have had from the firms, investors and analysts.

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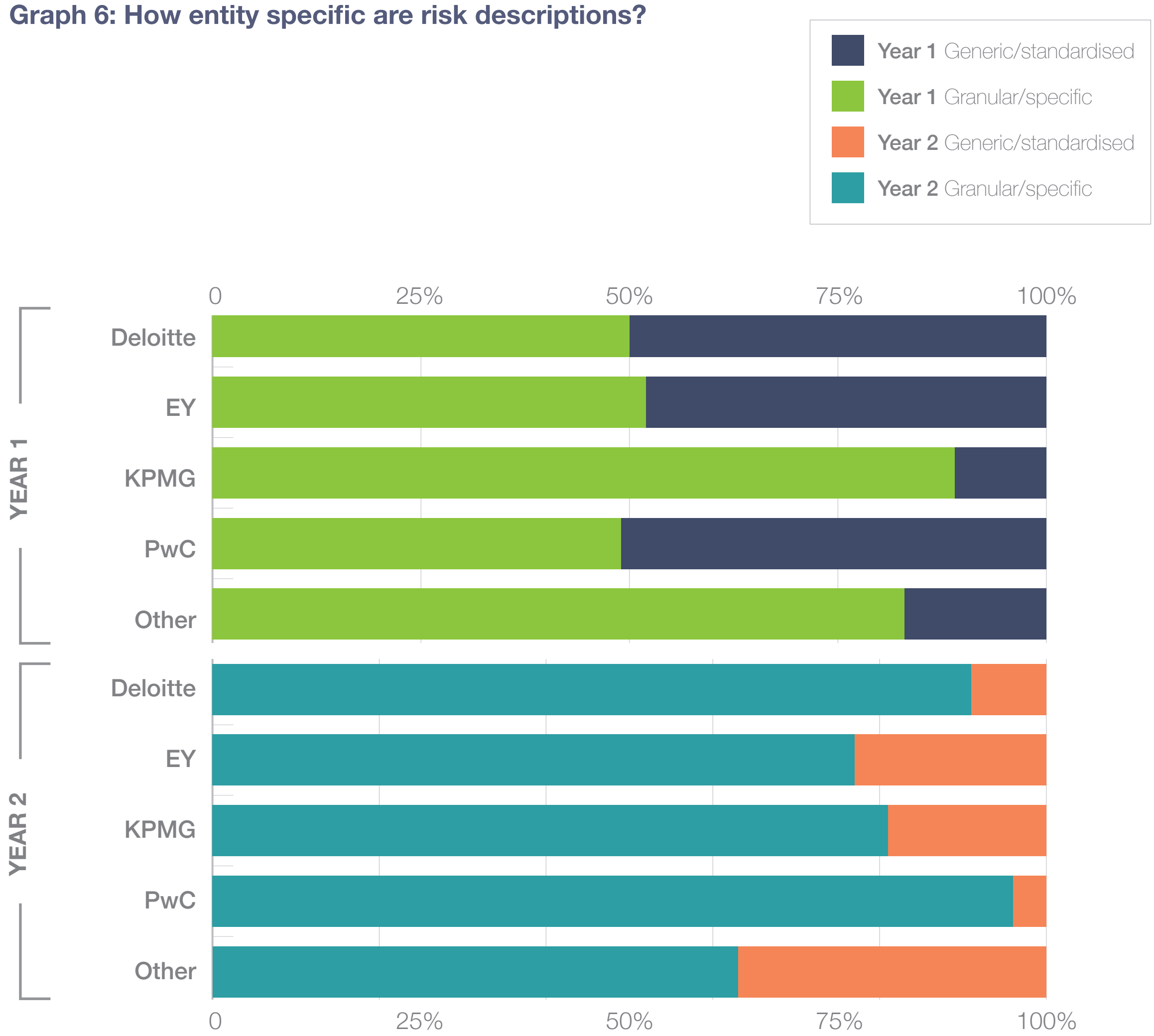
Graph 6: How entity specific are risk descriptions?



Source: ***FRC analysis***

Language

Investors also spoke to us about the language used in auditor reports, particularly in respect of areas of judgement or where the outcome of audit work sat within a range. Even where they do not set out the results of testing for an area of focus separately, auditors will typically describe their audit procedures in relatively generic terms. For example, in respect of a risk relating to potential impairment of goodwill the auditors of the London Stock Exchange Group PLC explained that, in addition to several other procedures:

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> *"We performed sensitivity analysis on the key inputs to impairment models, to understand the impact that reasonable alternative assumptions would have on the overall carrying value." [EY, London Stock Exchange Group PLC Independent auditor's report, p/e 31 December 2014]*

From the Glaxo report, the auditor offered the following commentary on findings on provisions for uncertain tax positions:

> *"From the evidence obtained, we considered the level of provisioning to be acceptable in the context of the Group financial statements taken as a whole. However we noted that the assumptions and judgements that are required to formulate the provisions mean that the range of possible outturns is broad." [PwC, GlaxoSmithKline plc Independent auditor's report, p/e 31 December 2014]*

Investors have told us that in the absence of information about what those 'reasonable alternative assumptions' were, this information has limited utility. The issue of how specific audits can be in their descriptions becomes more pronounced when auditors seek to provide information about the outcome of their testing. Investors clearly welcome the inclusion of findings into auditor reports, but would prefer greater transparency about assumptions made by management and benchmarks used by auditors. This is clearly a challenging area, since even examples where auditors have attempted to provide additional information about the outcome of their work to the readers of their reports might still be considered to fall below this expectation. As an example, the auditors of St James's Place, set out their response to a significant risk relating to an in-year acquisition:

> *"We applied significant downward adjustments in testing the sensitivity of the Directors' forecasts for renewal and new business….We noted no exceptions in our testing. The Directors' forecasts demonstrated sufficient headroom to support the carrying value of assets acquired even after significant downward adjustments were applied." [PwC, St James's Place plc Independent auditor's report, p/e 31 December 2014]*

In this case the auditor has used language intended to provide more information about the outcome of their work – disclosing that testing the range of outcomes included applying 'significant' downward adjustments to management's assumptions. Similarly, in reporting on a risk relating to the carrying value of goodwill and intangible assets for GlaxoSmithKline PLC the auditor stated:

"As a result of our work, we determined that the quantum of impairment recognised in 2014 was appropriate. For those intangible assets, including goodwill, where management determined that no impairment was required, we found that these judgements were supported by reasonable assumptions that would require significant downside changes before any additional material impairment was necessary." [PwC, GlaxoSmithKline plc Independent auditor's report, p/e 31 December 2014]

However, investors have told us that in auditor's reports more generally, they would prefer greater precision and that words like 'significant' are not necessarily sufficiently informative. Even in those reports which have been recognised to demonstrate best practice the difficulty for auditors to find appropriate language to describe management judgements poses an ongoing challenge. The Rolls-Royce report for the period ended 31 December 2014, reported findings against risks related to the measurement of revenue and profit in the Civil Aerospace business:

"Overall our assessment is that the assumptions and resulting estimates (including appropriate contingencies) resulted in mildly cautious (2013 audit finding: mildly cautious) profit recognition…." [KPMG, Rolls-Royce plc Independent auditor's report, p/e 31 December 2014]

This issue with language is one that has been recognised by one of the firms:

"All those we spoke to agreed that having the results of our work included in the audit report was helpful and informative. That said, we still have further to go in terms of using more clear and consistent language and being definitive about whether or not we have a concern." [PwC, The revolution in audit reports, August 2015, p6]

Conciseness

Investors have also told us that they value information particularly highly when it is presented in a concise way. This creates a particular challenge for auditors, since at the same time they are being asked to convey granular information about highly technical matters in a concise and easy to understand way. This therefore prompted us to review the volume of disclosure, as well as its content. We analysed the average word count for the risk descriptions in each report, and the results are presented in the table below.

Table 3: Average word count in the risk sections of extended auditor's reports

Firm	Deloitte	EY	KPMG	PwC	Others
Average word count (All)	893	971	992	1557	787
Average word count (FTSE 100)	972	1046	1205	1858	1256
Average word count (FTSE 250)	869	939	902	1319	720

Source: ***FRC analysis***

In summary:

- On average, descriptions of risk tend to be longer for FTSE 100 companies than for FTSE 250. This may be because these are generally larger and more complex businesses.
- Of the audit firms, PwC tend to include longer descriptions of risk in all their reports. This reflects the way that firm has sought to provide greater transparency and detail in reporting of risk, but highlights the challenge of meeting potentially contradictory expectations from the users of the reports.

Clear signposting of information, and a focus on material issues may mitigate any concern that overall risk descriptions are too text heavy or 'dense' – but the clear difference in approach between firms demonstrates that this is often more of an art than a science, as well as a point of differentiation in the service provided.

Reporting Audit Findings

In year one of our survey we analysed the sample of auditor reports to identify those which included audit findings. This was an area of particular interest to investors which – if done well – provides insight into the auditor's judgements at the more granular level of identified risks rather than at the overall financial statement level. Some audit firms had expressed reservations about this approach because, in their view, the audit report is ultimately intended to convey an opinion at the financial statement level rather than for each identified risk. This concern is reflected in application guidance to the international ISA's which the FRC is currently proposing to adopt in the UK and Ireland:

> *….the auditor may also provide an indication of the outcome of the auditor's response in the description of the key audit matter in the auditor's report. However, if this is done, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual key audit matter or that in any way may call into question the auditor's opinion on the financial statements as a whole. [proposed ISA (UK and Ireland) 701, A.51]*

However, the effect of the standard is not to prohibit the inclusion of observations of this kind, but to require auditors to carefully consider their content. In year one we identified only a very small population of audit reports which included commentary on findings against key audit matters (3 reports or 2% of our sample). These were all produced by one partner at KPMG and were intended to demonstrate to audited entities and users of accounts the level of detail which could be made available. These reports were particularly well received by many investors, earning praise at the 2014 The Investment Association Auditor Reporting Awards for the insight and the value that they added. In respect of the report on Rolls-Royce the judges commented that:

3

> *"Under the assessment of risks of material misstatement, the auditor outlines the risk, the auditor's response and importantly what they found. The inclusion of findings was a step further than other auditors and provided a real value add, giving colour as to whether management's judgements were balanced, mildly optimistic or mildly pessimistic in the view of the auditor. The auditor turned over the rock and reported what they had found." [FRC report year one, p.55]*

KPMG subsequently made a public offer to clients to make this type of auditor's report available on request. However, having reviewed auditor's reports in detail, comparatively few entities opted to take up KPMG's offer.

The table below sets out the results of our survey from year two:

Table 4: Reports which include audit findings for risks of material misstatement

	2015		Total	2014		Total
	Yes (includes findings)	No		Yes (includes findings)	No	
FTSE 100	24	65	89	1	62	63
	27%	73%		2%	98%	
FTSE 250	32	157	189	2	88	90
	17%	83%		2%	98%	
Total	56	222	278	3	150	153
	20%	80%		2%	98%	

By Firm:	PwC	KPMG	Deloitte	EY	Other	Total
2014	0	3	0	0	0	3
2015	44	5	4	3	0	56
% of total 2015 reports	79%	9%	7%	5%	0%	

Source: ***FRC analysis***

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Overall there has been an increase in the number of auditor's reports including a commentary on findings against key audit risks – up to 20% of our overall sample as against 2% in year one. This increase has been primarily driven by one firm, PwC, who have committed to this approach for their entire client portfolio.

We also noted that two of the auditor reports which were commended in the 2015 Investor Association awards did include findings, even though that was not the general policy for the firms involved. In both cases the audit committees for the audited entities had specifically requested this approach.

In the course of preparing our report, we have spoken to the largest audit firms and have had feedback from investors. Whilst there is recognition that there continue to be enhancements in this area, there is some disappointment amongst the investor community that the approach adopted in last year's Rolls-Royce auditor's report has not been adopted more widely – or that some similar innovation has not emerged. Although PwC have enhanced their reporting in this area they have done so by integrating their commentary on findings into the text of their response to areas of significant risk:

> *"Audit reports give an opinion on the truth and fairness of the financial statements as a whole. They're not designed to give assurance on individual parts of the financial statements. The challenge in presenting the results of our work was to avoid creating the impression of 'mini-opinions' against each of our areas of focus. So we decided not to present a 'conclusion' or 'findings' at the end of each risk and response, but instead incorporated the results of our work into the description of our response to each risk. This also meant that we could answer the 'so what?' question without disrupting the flow of the narrative. This approach is certainly more subtle than some of our competitors, but we believe it leads to a greater level of insight. Our audit partners are 'telling the whole story of their audit'." [PwC, The revolution in audit reports, August 2015, p6]*

On a purely practical level this approach can sometimes make it difficult to identify the auditor's conclusions and findings within the more generic statements of the audit response to those risks. In some cases PwC auditors did highlight the findings sections of their commentary on areas of audit focus, for example in the report for ARM Holdings PLC, but this was in a minority of cases.

We asked the audit firms why the 'KPMG' approach had not been adopted more widely in year two. The firms told us that whilst they were happy to innovate, this had to be done in agreement with the audited entities and there had been little evidence of a significant appetite from them to disclose more detail about what had been found at this level of granularity; and, indeed, in some cases there had been some reluctance. It was not clear where this reluctance arose from, although some audited entities perceived this to be an irrevocable step which therefore needed to be carefully managed.

We also found very few examples where auditors reported whether errors were found during testing, the quantum of any errors identified and what was done as a result. The report for Intermediate Capital Group was highly unusual in disclosing the tolerable threshold used in testing the valuation of Collateralised Loan Obligations, and the adjustment made by management as a result of audit testing. This was one of the reasons why they won their The Investment Association Award category for reporting on risks of misstatement:

> *"The results of our fair value testing for these CLO tranches fell outside a tolerable threshold of 5%. Based on these results, we believed that CLOs were misstated. After communicating these errors to management, they fair valued the loan tranches using their cash flow model to determine the CLO tranche prices. Management agreed to post the correction of the misstatement resulting in a decrease of the CLO balance by £504,000. We are now satisfied that the valuation of CLOs at year end is acceptable." [Deloitte, Auditor's Report Intermediate Capital Group PLC, p/e 31 March 2015]*

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Explanations for changes to risk profile

In common with most other aspects of auditor reporting we found very few examples where auditors explained the change in risk profile between years. We analysed a sample of 110 auditor's reports from within our larger sample, which was drawn broadly in proportion to the market share of each of the larger audit firms. We then identified those content elements which had won praise during the investor awards. The table below sets out the results, and highlights the relative scarcity of this kind of commentary. The most commonly included content was some kind of description of the change in risk profile or areas of focus which was particularly prevalent in the audit reports of particular firms – but this was still present in only 22% of our sample.

Table 5: Analysis of auditor report contents

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%

Source: ***FRC analysis***

We also analysed by audit firm, looking for meaningful references to changes since the prior year (and excluding, for example, reports which simply included comparative figures).

Table 6: Inclusion of explanations of change

Firms	Reports including explanations of change	% of reports samples
PwC	0	0%
KPMG	3	3%
Deloitte	15	14%
EY	12	11%
Other	0	0%

Source: ***FRC analysis***

Examples where this was done includes the audit report for Land Securities:

> *"This year we have included accounting for complex acquisitions and disposals and consideration of transaction arrangements as a risk of material misstatement given that a number of such transactions have taken place in the financial year. Last year we included the risk of management override of controls as a risk of material misstatement; this year we have excluded this separate risk given that, in our view, the risk of management override relates specifically to the risks of material misstatement in relation to the valuation of the investment property portfolio and revenue recognition as set out in the table below." [EY, Land Securities Independent auditor's report, p/e 31 March 2015]*

Even rarer still were explanations of why risks had stayed the same for each year, with Deloitte's report on Sky PLC being one of the few examples:

> *"There has been no significant change in the Group's operations nor in our assessment of materiality, therefore the assessed risks of material misstatement described below, which are those that had the greatest effect on the audit strategy, the allocation of resources in the audit, and directing the efforts of the engagement team, are the same risks as in the prior year." [Deloitte, Sky Independent auditor's report, p/e 30 June 2014]*

By providing this commentary the auditor has provided insight into the risk assessment process which is otherwise only implied – that they consider the fundamentals unchanged between the years.

Number of Risks

We have also collected data on the number of risks reported by each audit firm in our sample. This is presented in the table below. In year one a significant number of audit reports included the presumed risks of management override of controls and of fraud in revenue recognition. However, the FRC did not intend that these risks should be routinely reported unless they have the qualifying characteristics set out in the ISAs (UK and Ireland): "those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team." [ISA (UK and Ireland) 700, 19A (a)]

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Table 7: Number of reported risks of misstatement

	Year 2					Year 1				
	Deloitte	EY	KPMG	PwC	Others	Deloitte	EY	KPMG	PwC	Others
Highest number of risks reported	8	8	7	8	6	7	8	10	9	9
Lowest number of Reported Risks	2	1	1	1	2	2	1	1	3	2
Average Number of Risks reported FTSE 350	4.1	3.9	3.1	4.4	3.6	4.0	4.1	3.6	4.9	3.8
Average Number of Risks reported FTSE 100	4.5	4.3	3.8	5.3	5.0	4.2	5.3	4.7	5.5	6
Average Number of Risks reported FTSE 250	4.0	3.7	2.8	3.7	3.4	3.9	3.6	2.9	4.2	3.4

Source: ***FRC analysis***

Consistent with our findings by sector, there has been no significant change in the number of risks included in auditor reports, although there has been a slight narrowing in the range. This indicates that – in aggregate – auditors have tended to replace the mandatory management override and fraud in revenue recognition risks with others.

The data does show a distinct difference between the number of risks included for the FTSE 100 and the next 250 biggest listed companies. This may again reflect the different levels of complexity between the populations – although it is perhaps surprising that the difference is quite so clear cut.

Section 4: Materiality

Introduction

ISA (UK and Ireland) 700[8] establishes the requirement for the auditor's report to explain how the auditor applied the concept of materiality in both planning and performing the audit. The auditor is, therefore, required to specify the threshold that they have used for materiality for the financial statements as a whole. The standard includes additional examples of possible content including:

- Materiality level or levels for classes of transactions lower than for financial statements as whole;
- Performance Materiality, which means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. It also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures;
- Revisions in Materiality in the course of the audit;
- Threshold for reporting unadjusted errors to the audit committee; and
- Significant qualitative considerations relating to materiality.[9]

In last year's report we published extracts from audit reports illustrating the way in which auditors explained their application of the concept of materiality. These tended to be fairly generic in nature, and did not provide much information about the risk assessment which informed the auditor's judgement.

Investors we spoke to as part of our survey in the second year continued to identify this as an area where auditors could do more, particularly with more meaningful explanations of the rationale for selecting a particular benchmark, adjustments made to it in calculating materiality, how materiality affected the scope of the audit and other ways in which materiality impacted on the conduct of the audit. The audit firms themselves have reported that their own shareholder feedback is consistent with this view on materiality.[10]

These issues are not unique to the UK. In the Netherlands, for example, one investor group responded to 'pilot' disclosures for new extended auditor reports by writing to the audit firms in 2014:

> *"….most 'new' audit reports still do not really explain to investors what the rationale was for setting the materiality threshold and how it was applied in practice. Investors would expect a link between any inherent accounting estimate risk of certain business models and the materiality threshold….Investors can do with a higher materiality level on the estimation for an impairment of goodwill, but we expect reporting entities to scrutinise their reported cash position and remuneration to the last dime."*[11]

8 ISA (UK and Ireland) 700: The Independent Auditor's Report on Financial Statements – Revised September 2014.
9 ISA (UK & Ireland) 700, A13.B.
10 See for example PwC's August 2015 report on The revolution in audit reports, p.8.
11 Eumedion, Corporate Governance Forum. http://eumedion.nl/en

Benchmarks

Auditors generally accepted in the first year of extended auditor reporting that they should disclose the benchmark that they used to set materiality for the financial statements as a whole, as well as the percentage level applied to that benchmark (although strictly neither of these were mandatory requirements). This information is considered extremely useful by users of financial statements, in understanding the nature of the judgements made by auditors, and also allows comparability to the approach used in other entities.

In year one we identified only a very small sample of audit reports where the benchmark for materiality was not disclosed. There were no such examples in this second year, and all those entities where the disclosure was not made in the prior year did disclose in the current year. However, our analysis also demonstrates that less than half of auditor's reports provide a rationale for the benchmark selected, and that practice varies significantly by firm. [see graph below]

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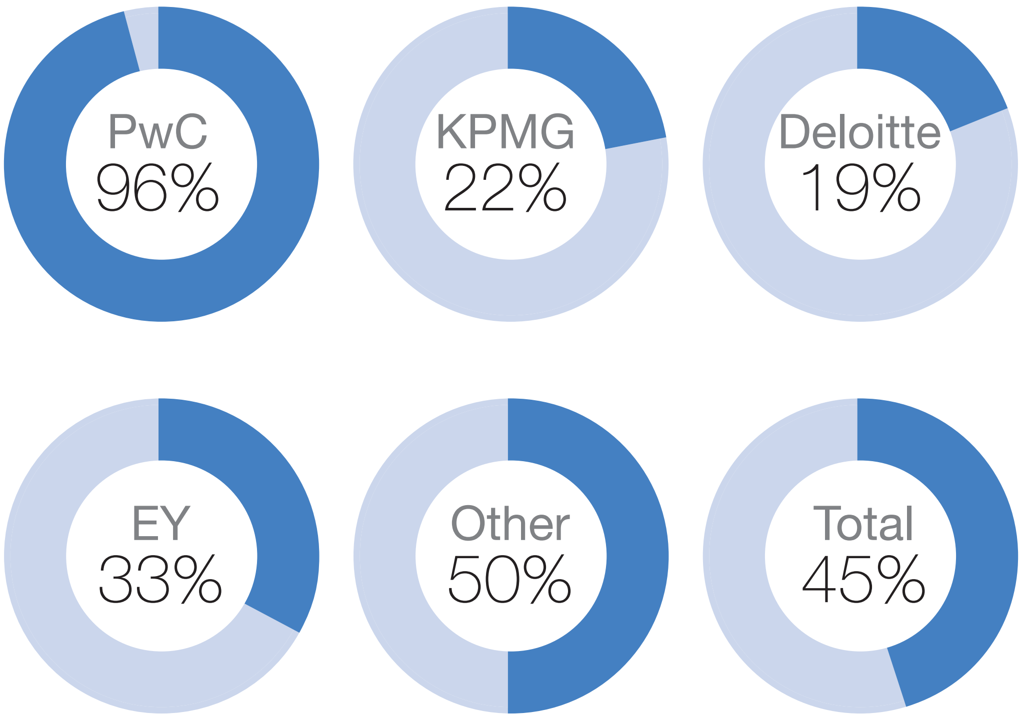
Graph 7: % reports explaining benchmark rationale

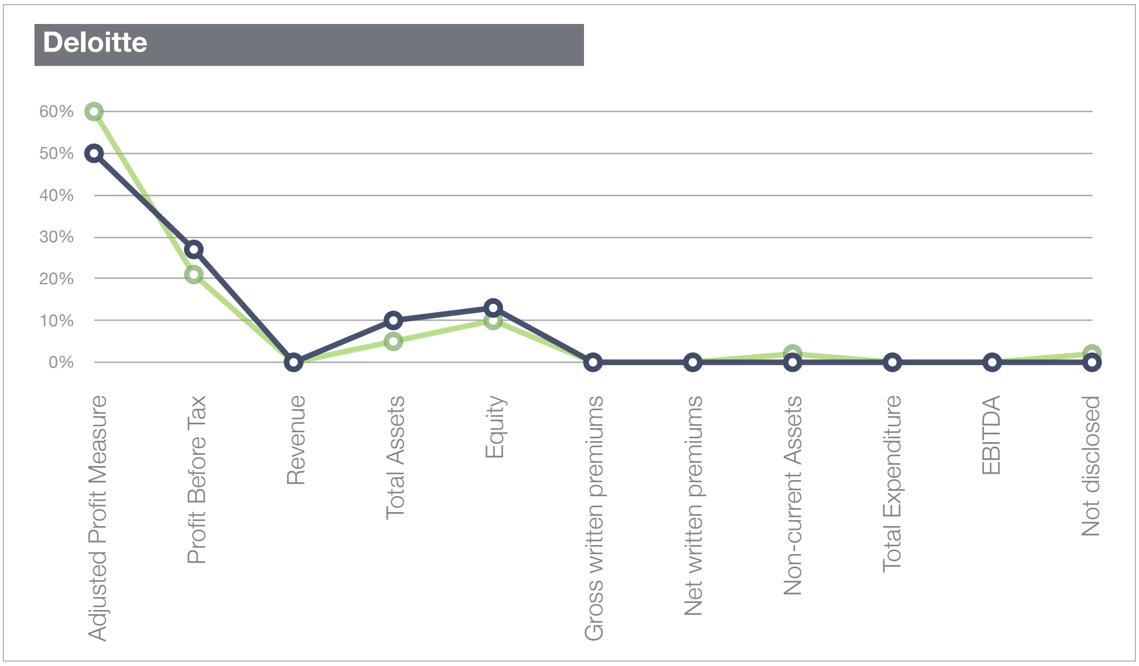


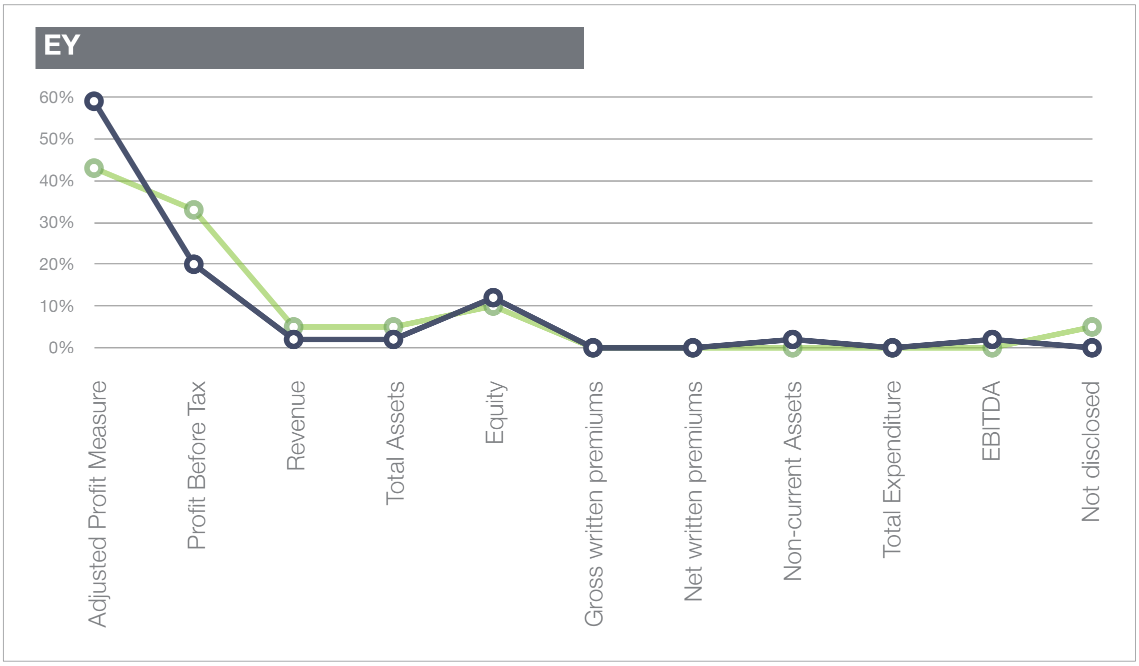
Source: ***FRC analysis***

Graph 8 below sets out the results of our review this year, with a comparison to year one. The graph sets out the percentage of audits within our sample using each type of measure, split out by audit firm. Profit measures remain the most popular benchmark, with almost half of all auditors using an adjusted measure. There is a slight difference in approach between the firms, based on the sample we reviewed, with Deloitte, PwC and EY more likely to use an adjusted profit measure for their audits, and KPMG more likely to use an unadjusted measure.

Graph 8: Benchmark by Firm

Y2 Y1





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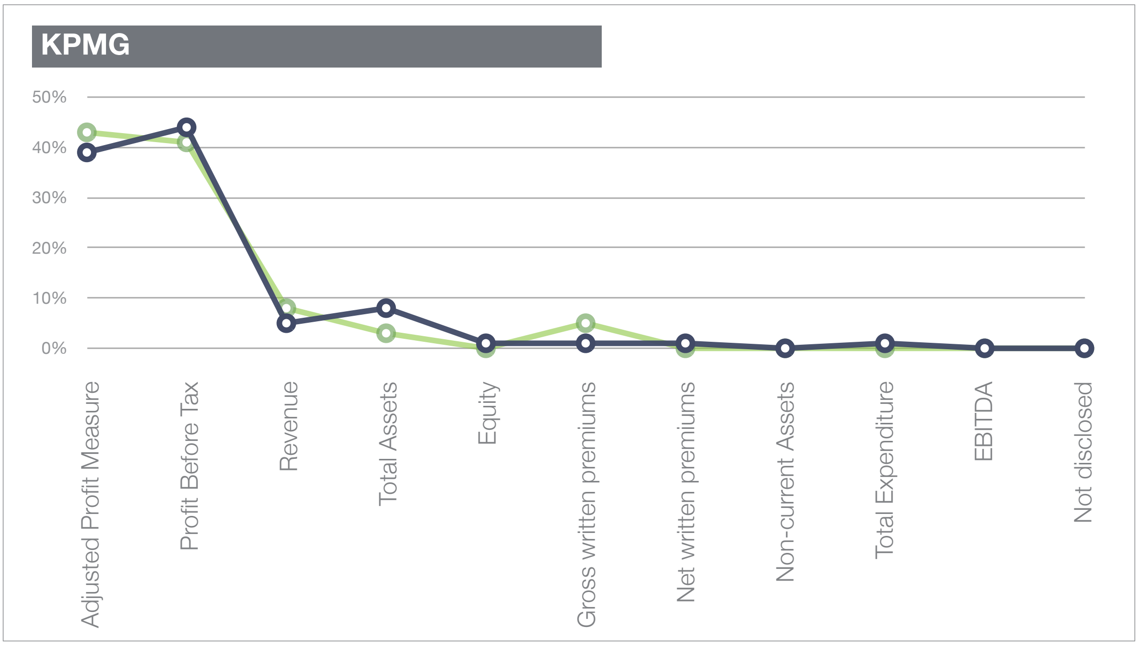

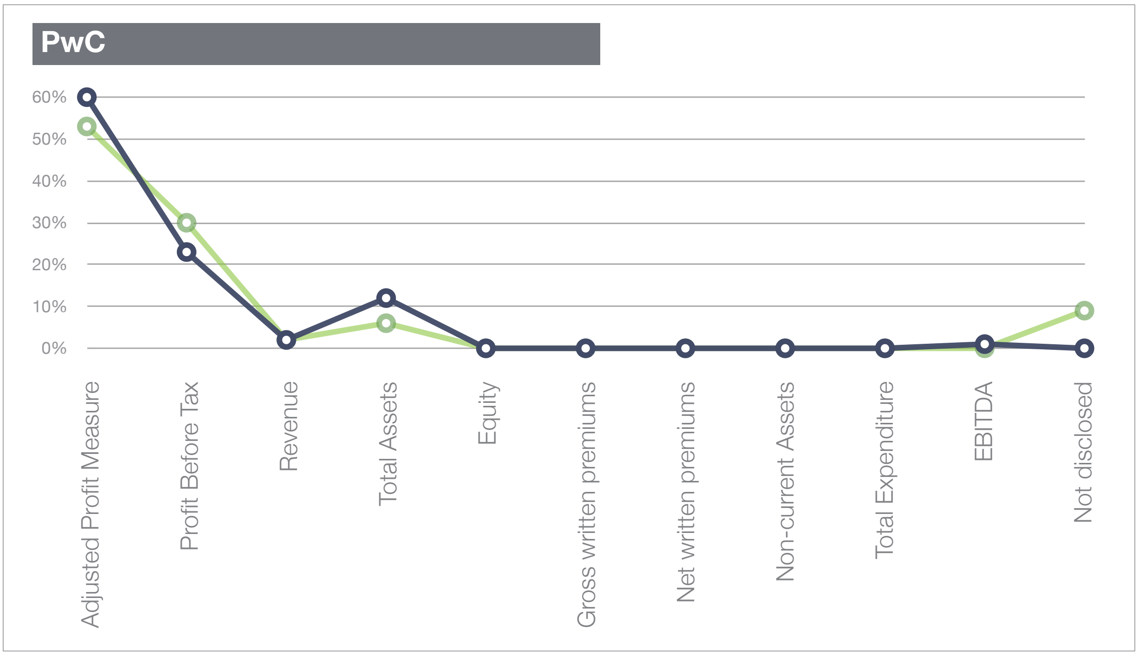

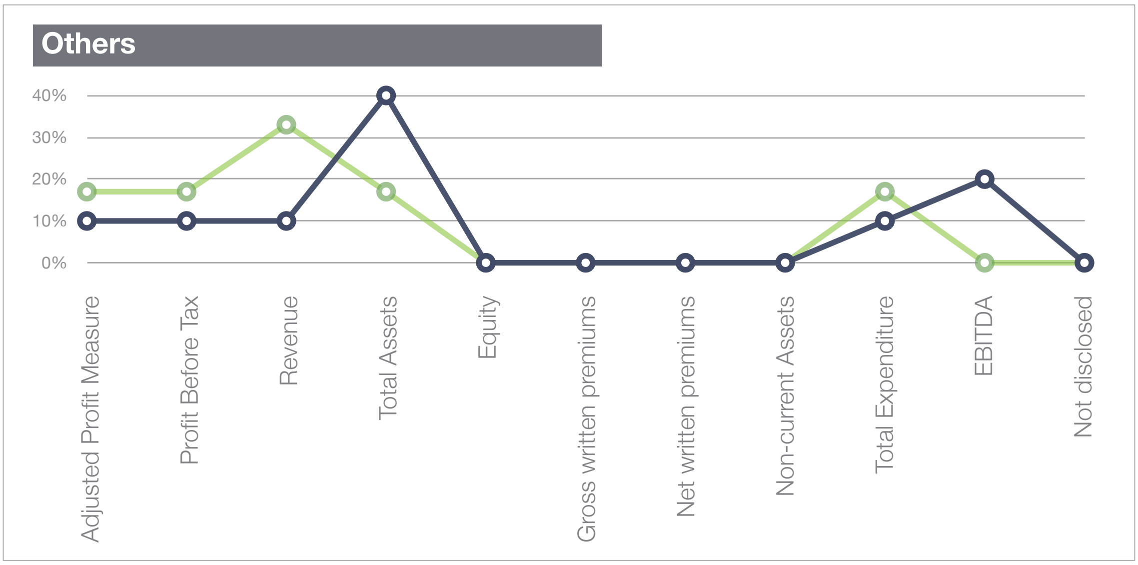

Source: ***FRC analysis***

Adjusted Profit

When an adjusted profit measure was used, we found a significant level of judgement being applied by auditors in the items adjusted for. Transparency around these judgements is one of the aspects of materiality which has been a cause for concern for investors. The most common argument for making these adjustments is to strip out the impacts of volatility arising from non-recurring or exceptional items. The auditing standards say:

> *"In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results."[12][ISA (UK and Ireland) 320, A5]*

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From the investor perspective, however, it is often difficult to understand why different auditors adjust for items which others do not, or where auditors make different adjustments to the adjusted IFRS performance measure prepared and disclosed by management.

Change in Benchmarks

A minority of audit reports included an explanation for a change to the benchmark used to set materiality levels, or the percentage applied to benchmarks year-on-year. Investors have told us that they would welcome more granular information about materiality, including more explanation of the auditor's professional judgement in selecting both benchmarks and percentages. We note that the FTSE 100 auditor report which was judged by The Investment Association to have the best materiality disclosures also included an explanation of why materiality had fallen from £40m in the prior year to £28m in the current:

> *"Our materiality is lower than the level we set for the year ended 31 December 2013 to reflect: the disposal of the Group's international business, with a consequential reduction in profit and premium income; emerging market practice; and guidance issued by the Financial Reporting Council." [Deloitte, Direct Line Insurance Group Independent auditor's report, p/e 31 December 2014]*

12 ISA (UK and Ireland) 320: Materiality in Planning and Performing an Audit, A5

A similar disclosure was included by the same firm in the report for another listed entity:

"We have reduced the percentage basis for the calculation of materiality from 7.5% to 5%. The continued improvement in the wider economic environment and the impact on the profitability of the Group means that, in our judgement, a level of 5%, is more appropriate." [Deloitte, Taylorwimpey Independent auditor's report, p/e 31 December 2014]

Similarly, some auditors explained changes to the benchmark used year-on-year:

"The materiality for the Group financial statements as a whole was set at £15,500,000 for 2014. This was determined with reference to profit before tax, of which it represents 6.9%. In 2013, materiality was determined with reference to a benchmark of revenue. Following the Group's IPO at the end of 2013, which led to a significant reduction in the level of debt and therefore the amount of interest paid, we consider that profit before tax better aligns with the principal considerations of the shareholders of the Company, so for 2014 we changed our benchmark measure accordingly." [KPMG, Merlin Independent auditor's report, p/e 27 December 2014]

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Performance Materiality

ISA (UK and Ireland) 320[13] defines performance materiality as:

"The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures."[14]

Guidance within ISA (UK and Ireland) 700 includes performance materiality in a list of non-mandatory aspects of materiality which auditors may wish to cover in extended auditor reports.

13 ISA (UK and Ireland) 320: Materiality in Planning and Performing an Audit.
14 ISA (UK and Ireland) 320: Materiality in Planning and Performing an Audit, p.9.

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Based on our discussions with investors and other stakeholders there is evidence to suggest that performance materiality is less well understood as a benchmark measure outside the audit profession when compared to materiality for the financial statements as a whole. As a more technical concept, there may be a greater challenge for auditors in conveying its meaning, significance and impact on the audit to the users of accounts. It is possible that this is one of the reasons why very few audit firms have chosen to discuss their approach to performance materiality in the auditor's reports produced in the first and second years, despite the significant innovation demonstrated elsewhere.

Performance materiality is used to assess the risks of material misstatement and to determine the nature, timing and extent of further audit procedures.[15] Performance materiality is about precision – a professional judgement based on the auditor's assessment of risk within an entity which is designed to reduce the risk of undetected material misstatement to an "appropriately" low level. The percentage 'haircut' applied by an auditor to materiality can give readers insight into the level of risk perceived by an auditor, as distinct from materiality which is designed to reflect the external view of risk, or the level of error which might influence the economic decisions of users of accounts. It may be possible, therefore, to conclude that the auditor perceives a higher level of risk of error when a lower percentage is selected. There is evidence that investors in particular value explanations about changes in the benchmarks used by auditors. The audit report for UBM plc, for example, won the 'other premium listed' The Investment Association award in the Materiality category, and includes commentary on how the audit risk assessment impacted on performance materiality:

> *"On the basis of our risk assessment, together with our assessment of the Group's overall control environment, our judgement was that overall performance materiality (i.e., our tolerance for misstatement in an individual account or balance) for the group should be 50% (2013: 75%) of planning materiality, namely £3.5m (2013: £6.0m). The rationale for applying a lower performance materiality in the 2014 audit was to reflect the risk associated with the implementation of a new financial system and processes in both the UBM Live EMEA and the UBM Americas businesses during the year and the significant acquisition of Advanstar in December 2014" [EY, UBM Independent auditor's report, ye 31 December 2014]*

Similarly the auditors of Next PLC explained an increase in performance materiality from 50% to 75%:

> *"….as a result of limited historical audit findings in prior years, except for the judgements and estimates associated with the areas of significant risk." [EY, Next PLC Independent auditor's report, p/e 24 January 2015]*

15 ISA (UK and Ireland) 320: Materiality in Planning and Performing an Audit, p.11.

In our 2013 report “Audit Quality Thematic Review: Materiality” we set out materiality related findings from our audit quality inspections, and highlighted the need for auditors to apply judgement when setting performance materiality:

> *“Auditors should demonstrate the consideration of risk in setting performance materiality and avoid, as a default, simply setting this at the highest level allowed under their firm’s guidance.” [AQR Report, p.6]*

Each firm had its own internal guidance for setting performance materiality, and we set out the ranges they had used on an anonymised basis [AQR Report, p.6]:

	Firm 1	Firm 2	Firm 3	Firm 4	Firm 5	Firm 6
Percentage of Materiality	50 to 75%	75 to 60% (default set to 75%	50 to 75%	75% max	50 to 75%	90% max
Percentage of audits reviewed using the highest percentage allowed	100%	Over 50%	100%	100%	Under 25%	Between 25 and 50%

The findings of our audit inspections indicated a tendency for auditors to default to the highest allowable percentage within their firm’s guidance, with a consequent lack of explanation and documentation around this judgement within audit files.

In those auditor’s reports we have examined this year, which include performance materiality, (which are those issued by EY), we noted that despite the extension of our data sample, the relative percentage of audits applying the lower 50% threshold for performance materiality remains broadly the same year on year. No additional firms have chosen to disclose performance materiality in the second year of extended auditor’s reports. The table below shows that BDO have now stopped reporting performance materiality – at least the percentage haircut applied in the first part of the ISA 320 definition – and now report instead the lower threshold they use to audit some specific classes of transactions, balances and disclosures.

The comparability of information on performance materiality is reduced where so few auditors disclose it. This makes it impossible for investors using publicly available information to make meaningful comparisons between the approaches adopted by different audit firms, and the relative audit risk that auditors have associated with entities that may be operating in the in the same business sector.

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Table 8 : Performance materiality disclosures

Auditor	Performance Materiality set at 50% of planning materiality		Performance Materiality set at 70% of planning materiality		Performance Materiality set at 75% of planning materiality		Total
Year 1							
Deloitte	0	0%	2	100%	0	0%	2
EY	10	53%	0	0%	9	47%	19
BDO	0	0%	0	0%	3	100%	3
Haysmacintyre	0	0%	0	0%	1	100%	1
							25
Year 2							
EY	22	51%	0	0%	21	49%	43
Grant Thornton[16]	0	0%	2	67%	1	33%	3
Haysmacintyre	0	0%	0	0%	1	100%	1
							47

Source: ***FRC analysis***

16 Grant Thornton were not captured in our first year sample.

Section 5: Audit Scope

Introduction

ISA (UK and Ireland) 700 requires the auditor to, "provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed…. and was influenced by the auditor's application of materiality…."[17] In the same way as with the materiality standard ISA (UK and Ireland) 320[18], there is a list of suggested potential content for the report:

Such a summary might also include, for example:

- The coverage of revenue, total assets and profit before tax achieved;
- The coverage of revenue, total assets and profit before tax of reportable segments achieved;
- The number of locations visited by the auditor as a proportion of the total number of locations, and the rationale underlying any programme of visits;
- The effect of the group structure on the scope. The audit approach to a group consisting of autonomous subsidiary companies may differ from that applied to one which consists of a number of non-autonomous divisions; and
- The nature and extent of the group auditor's involvement in the work of component auditors. [ISA (UK and Ireland) 700 A13C]

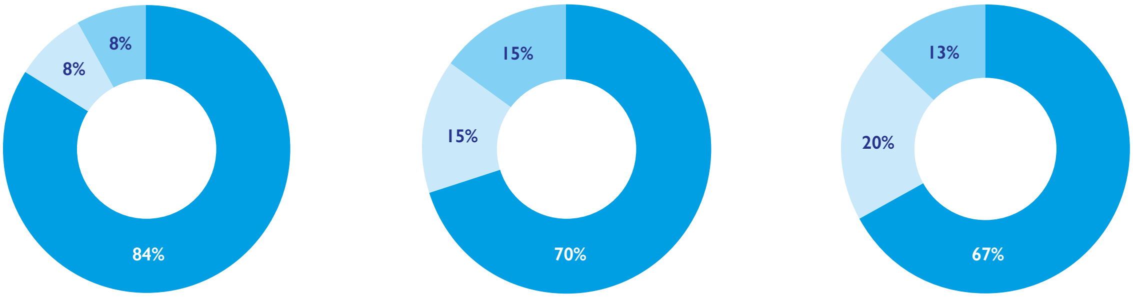
What auditors report

In the vast majority of reports we reviewed auditors included most of the information suggested by the standard. However, the extent and clarity of disclosure varied considerably.

As in the prior year survey there were examples of extensive disclosures about scope, including the use of clear graphics and diagrams to help the reader understand the extent of testing across the group as a whole, and between different components. Many of KPMG's audit reports, for example, broke down audit coverage by full scope, specific-risk focussed audit procedures and aggregate analytics for each of three benchmarks: profit and losses before tax, revenue and assets. This included both a diagrammatic and detailed narrative explanation:

17 ISA (UK and Ireland) 700: The Independent Auditor's Report on Financial Statements – Revised September 2014, p.19A c.
18 ISA (UK and Ireland) 320: Materiality in Planning and Performing an Audit.

Scope of our work



Profit and losses before tax (absolute)

Revenue

Assets

Key Audit | Specified-risk focused audit procedures | Analysis at an aggregated level

The materiality for the Group financial statements as a whole was set at £15,500,000 for 2014. This was determined with reference to a benchmark of profit before tax, of which it represents 6.9%. In 2013, materiality was determined with reference to a benchmark of revenue. Following the Group's IPO at the end of 2013, which led to a significant reduction in the level of debt and therefore the amount of interest paid, we consider that profit before tax better aligns with the principal considerations of the shareholders of the Company, so for 2014 we changed our benchmark measure accordingly.

We agreed with the Audit Committee that we would report all corrected and uncorrected misstatements identified through our audit with a value in excess of £775,000, in addition to other audit misstatements below that threshold that we believe warranted reporting on qualitative grounds.

We audited 84% of the total profits and losses that made up Group profit before tax, 70% of total Group revenue and 67% of total Group assets. This included the audit, for group reporting purposes, of the financial information of certain components, audit procedures on certain total Group account balances that present individual risks, specifically interest expenses, and assets arising on consolidation. The components containing these Group account balances were not individually financially significant and therefore did not require an audit for group reporting purposes. Audits for group reporting purposes, including those performed by the Group audit team, were performed at components in the following locations: UK, USA, Australia, Denmark, Germany, Italy and Hong Kong.

The remaining 16% of total profits and losses that made up Group profit before tax, 30% of total Group revenue and 33% of total Group assets was represented by a large number of smaller reporting components, as the majority of attractions sit within their own statutory entity and there are a large number of intermediary holding companies. None of these components individually represent more than 3.2% of any of the total profits or losses that made up Group profit before tax, total Group revenue or total Group assets. We obtained further coverage by performing specified risk-focused audit procedures over the reasonableness over the financial result and position at 15 of these reporting components. For the remaining components, analysis at an aggregated level was performed to re-examine our assessment that there were no significant risks of material misstatement within these.

The Group audit team carried out audits for group reporting purposes of the financial information of components covering 47% of the total profits and losses that made up Group profit before tax, including the only individually financially significant component, Merlin Attractions Operations Limited. The Group audit team also undertook all audit procedures of certain total Group account balances as mentioned above, gaining coverage over a further 15% of the total profits and losses that made up Group profit before tax. The largest component audited by a component audit team represented 8% of the total profits and losses that made up Group profit before tax.

[Merlin Entertainments PLC Audit Report, p/e 31 December 2014]

EY also adopted this approach for their audit of BG Group PLC, which won The Investment Association award for best description of audit scope from the FTSE 100:

5. Our application of materiality
We apply the concept of materiality both in planning and performing our audit, and in evaluating the effect of misstatements on our audit and on the Financial statements. For the purposes of determining whether the Financial statements are free from material misstatement we define materiality as the magnitude of misstatement that makes it probable that the economic decisions of a reasonably knowledgeable person, relying on the Financial statements, would be changed or influenced.

We initially determined materiality for the Group to be $300 million (2013: $375 million), which is approximately 5% (2013: 5%) of Business Performance* profit before tax, and approximately 1% (2013: 1%) of total equity. We have calculated materiality with reference to the Group's Business Performance as we consider this to be one of the principal considerations for members of the Company in assessing the financial performance of the Group. This is on the basis that Business Performance excludes one-off items and fair value measurement of commodity contracts. It is the key earnings measure discussed when the Group presents the financial results. This provided a basis for determining the nature, timing and extent of risk assessment procedures, identifying and assessing the risk of material misstatement and determining the nature, timing and extent of further audit procedures. Our evaluation of materiality requires professional judgement and necessarily takes into account qualitative as well as quantitative considerations implicit in the definition.

The oil price declined significantly during the course of our audit. The significant decline was in the fourth quarter of the year and did not have a significant impact on the full year Business Performance. However, there have been a number of material impairments, which have been audited individually and in full.

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement was that overall performance materiality (i.e. our tolerance for misstatement in an individual account or balance) for the Group should be 50% (2013: 50%) of planning materiality, namely $150 million (2013: $187 million). Our objective in adopting this approach was to ensure that total uncorrected and undetected audit differences in all accounts did not exceed our materiality level of $300 million.

Audit work at individual components is undertaken based on a percentage of our total performance materiality. The performance materiality set for each component is based on the relative size of the component and our view of the risk of misstatement at that component. In the current year the range of performance materiality allocated to components was $30 million to $113 million. This is set out in more detail in section 6 below.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of $15 million (2013: $18 million), as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in the light of other relevant qualitative considerations.

6. An overview of the scope of our audit
Our assessment of audit risk, our evaluation of materiality and our allocation of that materiality determined our audit scope. The factors that we considered when assessing the scope of the Group audit and the level of work to be performed at each location included the following: the financial significance and specific risks of the location; and the effectiveness of the control environment and monitoring activities, including Group-wide controls and recent internal audit findings.

Following our assessment of the risk of material misstatement to the Group Financial statements, we selected seven components (2013: seven) which represent the principal business units within the Group's two reportable segments and account for 78% (2013: 80%) of the Group's total assets and 75% (2013: 75%) of the Group's Business Performance pre-tax profit.

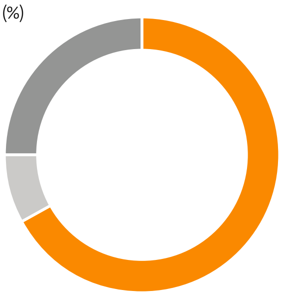
The components selected, together with the allocated performance materiality, were as follows:

Location and allocated performance materiality	$ million
Australia (full audit)	113
Brazil (specific audit procedures)	30
Egypt (specific audit procedures)	30
UK & Norway (full audit)	56
GEMS (full audit)	90
Kazakhstan (full audit)	56
Treasury (specific audit procedures)	98

Four of these locations were subject to a full audit (2013: four), whilst at the remaining three (2013: three) specific audit procedures were performed, including full audit of the accounts that were impacted by our assessed risks of material misstatement. For the remaining components, we performed other procedures to confirm there were no significant risks of material misstatement in the Group Financial statements. For those items excluded from Business Performance, primarily impairment charges, we applied a similar approach whereby our in-scope component audit teams performed audit procedures on items generated at the locations including Australia, Egypt and North Sea pre-tax impairment charges. The Group audit team performed procedures on the remaining items including the US and Tunisia pre-tax impairment charges and tax items.

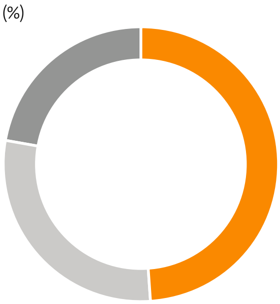
The charts below illustrate the coverage obtained from the work performed by our component teams:

BUSINESS PERFORMANCE: PROFIT BEFORE TAX
(%)



- **67%** Full audit
- **8%** Specific audit procedures
- **25%** Other procedures

TOTAL ASSETS
(%)



- **49%** Full audit
- **29%** Specific audit procedures
- **22%** Other procedures

The Group audit team continued to follow a programme of planned visits that has been designed to ensure that the Senior Statutory Auditor visits each of the locations where the Group audit scope was focused at least once every two years and the most significant of them at least once a year. For all full audit components, in addition to the location visit, the Group audit team reviewed key working papers and participated in the component team's planning, including the component team's discussion of fraud and error.

The audit reports which the audit firms themselves have identified as best practice examples, and which were recognised as such in the investor awards, were clearly designed to have a visual appeal, are clearly signposted and include a large number of diagrams.

Innovation

Consistent with our findings elsewhere in this report we noted that the pace of innovation had slowed in comparison to year one, when auditors had generally gone beyond the strict requirements of the auditing standards. However, the examples of enhanced reporting we noted last year continued to be evident, and some of the firms had attempted to improve them even further.

PwC, for example, have added a new contextual paragraph in some of their reports. This has been integrated into some but not all of the 'audit approach' overview sections and places the activities of the entity and therefore the audit into a wider context:

> *"The context for our audit is set by Cairn Energy PLC's ("Cairn") major activities in 2014, together with the significant fall in world oil prices in Quarter 4. In the year, Cairn has progressed to development stage their interest in Catcher North Sea field; raised finance for this and the other development project, Kraken; and completed a 4 well exploration drilling programme offshore North Africa….Away from core operations, Cairn's main focus has been dealing with enquiries from the Indian Tax Authorities relating to a group reconstruction…." [Cairn PLC, PwC Independent Auditor's Report, p/e 31 December 2014]*

The audit report for Wetherspoon's contained a similar disclosure:

> *"The context to our audit: Our 2015 audit was planned and executed having regard to the fact that J D Wetherspoon's operations were largely unchanged in nature from the previous year and the UK economy had a level of underlying low growth with no significant regulatory changes impacting the pub sector. In light of this, our approach to the audit in terms of scoping and areas of focus was largely unchanged, albeit we no longer had the determination of deferred tax liabilities as a heightened risk following the agreement reached by J D Wetherspoon in the prior year with HMRC as to items that would be deemed as qualifying capital expenditure for capital allowance purposes. We also had regard to the heightened regulatory focus on commercial income, but whilst we increased our work on this area, it was not a significant area of focus given the size of the amounts involved and the relative lack of complexity.." [PwC, JD Wetherspoons PLC, Independent Auditor's Report, p/e 26 July 2015]*

PwC have also introduced a new tabular 'overview' of audit approach covering materiality, scope and areas of focus.

Coverage of revenue, total assets and profit before tax

One area of particular interest to investors is the coverage given over revenues, profit and assets by type of audit activity. We analysed the disclosures made in year two reports, disaggregated by firm, which include this coverage. Graph 9 below sets out the averages for each measure and for each firm, which demonstrates a relatively narrow range between them.

Graph 9: Scope of audits: average coverage by profit measure, total assets and revenue

Source: ***FRC analysis***

5

Further enhancements

Feedback from investors has identified recommendations on how scope disclosures could continue to evolve and improve. They note that the very best examples of current disclosures provide clear and unambiguous information about the key content elements described above – including, for example, the coverage achieved by different types of audit activity. Despite the relatively narrow range identified in graph 9 above, which suggests no fundamental methodological divide between the firms, investors continue to be frustrated by disclosures which:

- Do not clearly distinguish between those elements of the financial statements covered by full scope audits, specific procedures or other analytics;
- Are not sufficiently clear about what the distinction between full scope and specified procedures might be;
- Do not link the assessment of risk and materiality to scope;
- Fail to clearly explain the rationale for group audit procedures at different locations and different parts of the business; and
- Do not provide adequate information about the quality of audit work performed by group auditors, particularly for international groups where component auditors are not necessarily working to the same auditing standards.

Section 6: Change of Auditor

As part of our analysis of reports this year we looked at a sample of 121 audits within the overall population to identify whether there had been a change of auditor, and to assess whether any potential reporting trends arose in these circumstances. Our analysis does not take account of circumstances where a tender has taken place and the incumbent firm was reappointed, so the data below does not reflect the total number of tenders in the period.

Table 9: Changes of auditor

Change of Auditor?			
	Yes	No	Total
FTSE 100	8	49	57
	14%	86%	
FTSE 250	3	61	64
	5%	95%	
FTSE 350	11	110	121
	9%	91%	

6

Source: ***FRC analysis***

The table below sets out some key data drawn from the audit reports of entities where there was a change of audit firm. In some cases, there were significant changes to the audit approach, including:

- a change in the benchmark used to calculate materiality (British Land Company); and
- a change in the number of assessed risks (Unilever).

In respect of Vodafone, Wm Morrison and British Land the incoming auditors made no reference to the benchmark used for the audit in the previous year, simply stating that they believed the benchmark for the current year to be the most appropriate. In the case of British Land the incoming auditors adopted a measure which increased financial statement materiality from £55m to £130m, having used asset values as the most appropriate materiality benchmark rather than equity. The reason for selecting an asset base – the significance of property valuations – was explained, but why the use of equity was less relevant in the current circumstances of the audited entity was not.

These changes illustrate a potential challenge for auditors, since in each case and in each year the auditor will have clearly set out a rationale for their risk assessment and approach to materiality. Audit firms will be naturally reluctant to comment on the approach used by different auditors. However such significant changes in approach between years may raise concerns unless they are addressed directly.

Table 10: Entities where there was a change of auditor between year 1 and year 2

Audited Entity	Vodafone Plc	WM Morrison Supermarkets Plc	The British Land Company Plc	Unilever Plc
year 1 audit firm	Deloitte	KPMG	Deloitte	PwC
Materiality Benchmark	Adj PBT	Adj PBT	Equity	PBT
Materiality	250,000,000	40,000,000	55,000,000	230,000,000
% used	5	not disclosed	1	5
Number of risks	5	6	2	6
year 2 audit firm	PwC	PwC	PwC	KPMG
Materiality Benchmark	3 year average Adj PBT	Adj PBT	Total Assets	PBT
Materiality	220,000,000	17,250,000	130,000,000	255,500,000
% used	5	5	1	4.6
Number of risks	7	5	5	3

Source: ***FRC analysis***

Section 7: Going Concern Basis of Accounting and Longer Term Viability Statements

Separate Going Concern Section of the Auditor's Report

Last year, we reported that a significant number of auditor's reports in our sample included a separate section on the going concern basis of accounting (89 reports, 58% of the sample). This went beyond the requirements of ISA (UK and Ireland) 700.[19] We noted that the great majority of these statements were generic in nature. We anticipated that changes to the Corporate Governance Code, which for periods starting on or after 1 October 2014 require companies to include a Viability Statement in their annual reports might be the spur for further innovation.

Our analysis of the second cohort of extended auditor's reports shows little change in this area, with 156 (56%) including an additional discrete section on the going concern basis of accounting. As in our previous sample this disclosure was largely limited to reports produced by PwC and Deloitte, and was generic in nature.

We identified a small number of reports which had a more tailored approach. As in our first survey the commentary for Lloyds Banking Group included additional detail about the procedures the auditors carried out when making their assessment of management's assertion of the appropriateness of the going concern basis of accounting. Other examples arose in the context of identified risks (Fresnillo, BG) or because the auditor included an Emphasis of Matter paragraph.

The BG Group auditor's report was innovative in its presentation of risks generally because of the inclusion of a separate section 'What we reported to the audit committee' – in effect a 'findings' section. In respect of the going concern basis of accounting this allows the user of the financial statements to understand the considerations made by both the auditor and the audit committee:

RISKS	OUR RESPONSE TO THESE RISKS	WHAT WE REPORTED TO THE AUDIT COMMITTEE
Going concern assessment, particularly in light of the recent oil price decline and decrease in forward prices.	*Our audit procedures included:* • *agreeing the assumed cash flows to the business plan, walking through the business planning process and testing the central assumptions to external data;* • *considering the impact of any delays in the receipt of cash proceeds from the Group's asset disposals;* • *confirming, through enquiry, the consistent application of the cash flow at risk methodology to assess the sensitivity of the underlying assumptions used in the going concern review; and* • *agreeing the standby facilities to underlying agreements and assessing the concentration risk.*	*Based on the results of our procedures, we are of the opinion that the Group has prepared a robust assessment that has considered appropriate sensitivities and stress scenarios, in particular a delay in receiving the cash from anticipated disposals. In assessing the robustness of the assessment, we have taken assurance from the level to which oil prices would have to fall for a sustained period for the stressed scenario to become a reality.* *We consider the decision to prepare the Financial statements on a going concern basis is appropriate.*

[EY, BG Group Independent Auditor's Report, p/e 31 December 2014]

19 ISA (UK and Ireland) 700: The Independent Auditor's Report on Financial Statements – Revised September 2014.

KEY CONSIDERATIONS	THE ROLE OF THE COMMITTEE	CONCLUSION
In response to the significant decrease in global commodity prices, the Group's reference conditions for the purpose of business planning, investment decision-making and impairment testing were reviewed in depth. This review also considered the stress tests applied to the Group's assessment of going concern.	*The Committee reviewed the processes and mechanisms in place to support the determination of the Group's reference conditions and going concern stress tests, in light of the decrease in global commodity prices and challenged management's judgements and assumptions in this regard.*	*The Committee supported management's judgements and assumptions regarding the impact of the sharp deterioration in commodity prices during the second half of 2014 which led to the recognition of significant impairment charges in Q4, as set out below. The Committee further supported management's assessment of the Group's status as a going concern for the year ended 31 December 2014.*

[BG Group Annual Report and Accounts, Audit Committee Report, p/e 31 December 2014]

FRC consultation on changes to auditing standards, including ISA (UK and Ireland) 570 Going Concern

The FRC has recently consulted on revisions to Auditing Standards (UK and Ireland) necessary to incorporate the requirements set out in the EU Audit Regulation and Directive, and changes made to international standards by the IAASB. In our discussions with some of the audit firms they indicated that unless there was a significant alternative factor in play, for example client demand, then it made more sense to wait for these new revisions to be finalised before further innovating their approach to reporting.

These proposed changes have the effect of clarifying the auditor's responsibilities in respect of going concern statements, and other disclosures under the Corporate Governance Code. This includes a requirement to 'conclude' on the appropriateness of management's use of a going concern basis in the preparation of the financial statements. They would also require auditors of all entities (not just listed or Public Interest Entities) to include a separate section in their report titled: Conclusions relating to Going Concern.

The FRC is also proposing to include more explicit requirements for auditors to consider the reporting about going concern risks in circumstances where no material uncertainty exists. This may lead to an increase in the number of going concern risks included in audit reports over time.

Viability Statements

Disclosure of viability statements became a formal provision of the UK Corporate Governance Code for accounting periods beginning on or after 1 October 2014, which is outside the scope of our current sample of reports. We did, however, review a sample of audit reports for the small group of 'early adopters' including Derwent London, BAE Systems, Intermediate Capital Group PLC, Lancashire Holdings and the FRC.

The Code requires that the Board states whether they believe that the entity will be able to continue in operation and meet their liabilities taking account of their current position and principal risks over a period significantly longer that the 12 month period generally covered by the traditional going concern statement. There is no prescribed timeframe or format for the statement, but the Board should specify the period covered by their statement and why they consider it appropriate. It is expected that investors and other users of financial statements will have a particular interest in these statements and the basis of management's assessment.

Auditors are required by current Auditing Standards to "determine whether the auditor has anything material to add or to draw attention to in the auditor's report on the financial statements in relation to these disclosures." [ISA (UK and Ireland) 570, 17-3] This 'by exception' reporting on the Viability Statement will continue under the revisions currently under consultation.

The FRC voluntarily published a Viability Statement as part of its financial statements for the period ended 31st March 2015, an extract of which is reproduced below in order to illustrate the nature of this new disclosure:

> *This statement covers the period to March 2019, which will mark the end of the FRC's next three-year planning period.*

> *For the reasons stated below, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of the assessment. We have therefore applied the going concern basis of accounting in preparing the annual financial statements.*

> *In making this assessment, the Directors acknowledge the authority of Government and Parliament in determining the FRC's future. While recognising that regulatory arrangements inevitably evolve over time in response to changing circumstances, we believe that it is reasonable to operate on the basis that the statutory and other responsibilities exercised by the FRC will continue to be required, and that the FRC will continue to be the organisation asked to deliver them.*

> *The role of the FRC was reviewed and confirmed by Government in 2012 and our powers were then extended. Since then, we have increased our monitoring of individual audits in response to the 2013 report by the Competition and Markets Authority on the provision of statutory audit services to FTSE 350 companies. It is possible that the Government may extend our responsibilities further by designating the FRC a competent authority for the purposes of audit regulation under the new Audit Regulation and Directive.*

> *The Directors anticipate that the FRC would have to increase its funding in order to carry out any additional responsibilities, and we are currently reviewing the basis on which we are funded.*

For the other ‘early adopter’ annual reports, we found only one separate reference in the auditor’s report to the Viability Statement. It will be required in future periods:

Entity	**BAE Systems**
Period Covered by the Viability Statement	Five years, consistent with the Integrated Business Planning Process
Auditor	KPMG
Reference to Going Concern Basis of Accounting in Auditor Report?	No
Reference to Viability Statement in Auditor Report?	No
Content of the Auditor’s statement	
Entity	**Derwent London PLC**
Period Covered by the Viability Statement	Five years, consistent with strategic review and pattern of underlying business
Auditor	PwC
Reference to Going Concern Basis of Accounting in Auditor Report?	Yes Separate section
Reference to Viability Statement in Auditor Report?	No
Content of the Auditor’s statement	

Table 11: Entities which have included viability statements

Entity	Intermediate Capital Group
Period Covered by the Viability Statement	Three years, consistent with business strategy and principal risks
Auditor	Deloitte
Reference to Going Concern Basis of Accounting in Auditor Report?	Yes Separate section
Reference to Viability Statement in Auditor Report?	Yes Within the separate section covering Going Concern issues
Content of the Auditor's statement	We have nothing material to add or draw attention to in relation to: The director's explanation on page 36 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.
Entity	**Lancashire Holdings Ltd.**
Period Covered by the Viability Statement	To 31st December 2016, consistent with the Group's current three year strategic plan
Auditor	EY
Reference to Going Concern Basis of Accounting in Auditor Report?	No
Reference to Viability Statement in Auditor Report?	No
Content of the Auditor's statement	

7

Source: ***FRC analysis***

Section 8: Location of the audit opinion

ISA (UK and Ireland) 700[20] does not mandate an ordering for the content of the auditor's report. This was deliberate, as we felt that a prescriptive template would stifle innovation and result in boilerplate reporting.

However, illustrative reports provided by FRC place the audit opinion after a description of the respective responsibilities of directors and auditor, and the scope of the audit. In our previous review we found that the majority of firms had instead placed the opinion at the beginning of the audit report (61%), with others including a short introductory paragraph first (27%). Only 10% followed the illustrative example from the standard, with EY producing 70% of their sampled reports in this latter format.

This approach, presenting the opinion at the beginning of the report, seems to have been generally welcomed by users of the financial statements, consistent with the aim of many users of financial statements for key information to be prominent and easy to locate. It also anticipates revised standards from the IAASB. The FRC is currently consulting on revisions to auditing standards which will implement changes in international standards to the UK and Ireland. In particular, the revised ISA (UK and Ireland) 700 will state that:

> *The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." [proposed revised ISA (UK and Ireland) 700]*

In 2015 there has already been a striking change, with 95% of the reports we reviewed across all firms having the opinion at the beginning, being the preferred format for users of the accounts.

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Table 12: Location of opinion

Location of Opinion	Year 2	Year 1
Opinion located first with no introduction	95%	61%
Opinion located after a brief introduction	4%	27%
Opinion follows FRC template and is after scope but before paragraph 19A disclosures	0%	10%
Opinion presented at the end	0%	2%

20 ISA (UK and Ireland) 700: The Independent Auditor's Report on Financial Statements – Revised September 2014.

Section 9: Audit Committee reporting of significant issues

The UK Corporate Governance Code and the requirements of UK Auditing Standards.

Provision C.3.8 of the UK Corporate Governance Code requires that a separate section of the annual report should describe the work of the Audit Committee in discharging its responsibilities. The report should include "the significant issues that the committee considered in relation to the financial statements, and how these were addressed". These "significant issues" are not necessarily identical to the "risks of material misstatement" that the auditor is required to include in an extended auditor's report.

By providing users with different but complementary perspectives on key financial reporting issues, both independent from management, the Audit Committee Report and extended auditor's report provide significantly enhanced insight into the companies they are reporting on. The FRC Financial Reporting Lab published the results of its Implementation Review on Audit Committee Reporting which found that, "investors indicated there should be interaction of the reporting of estimates and judgements across the Audit Committee report, auditor report, and accounting policy disclosures."[21] The FRC Lab report also noted that investors had similar concerns about qualitative aspects of audit committee reports as were initially the case for extended auditor reporting:

> *Improvement is recommended for the majority of companies in relation to the depth and quality of explanations. Also, to meet investor expectations, detailed explanations of considerations by the AC in relation to accounting judgements and estimates (not only impairment considerations which are often disclosed) could be included.*

How well aligned are extended auditor's reports with audit committee reports?

9

In our previous report we considered the extent to which the information contained in Audit Committee Reports was consistent with the information reported in extended auditor's reports. Whilst we recognise that there is no requirement for these two components to contain identical information, it is reasonable to expect a degree of complementarity. Allowing users to triangulate between the information presented by the preparers of financial statements, the Audit Committee and the auditor has the potential to significantly enhance the credibility and value of that information. It is also important to understand the way in which risk and assurance activity has been managed, and the extent of interaction between the Audit Committee and the auditor.

Our analysis is based on two sources of evidence. In the first instance we have completed a primarily quantitative analysis which looks at the correlation between significant issues identified in the Audit Committee Report, and the areas of audit focus in the corresponding auditor's reports. To allow comparability with the results from our prior year survey this has been presented on a sectoral basis in the table below. The second part of our analysis was a more qualitative assessment about the overall 'fit' between the information presented.

21 FRC Financial Reporting Lab: Reporting of Audit Committees – how companies responded to investor needs identified by the Lab; experience of the first year, May 2015

Quantitative Review

The quantitative assessment demonstrates a strong alignment between Audit Committee Reports and auditor's reports, which is consistent with our findings from last year. In general, Audit Committee Reports tend to highlight more issues than the equivalent auditor's reports, but not by a significant factor. [see Table 13 below] This is perhaps unsurprising given the remit of Audit Committees.

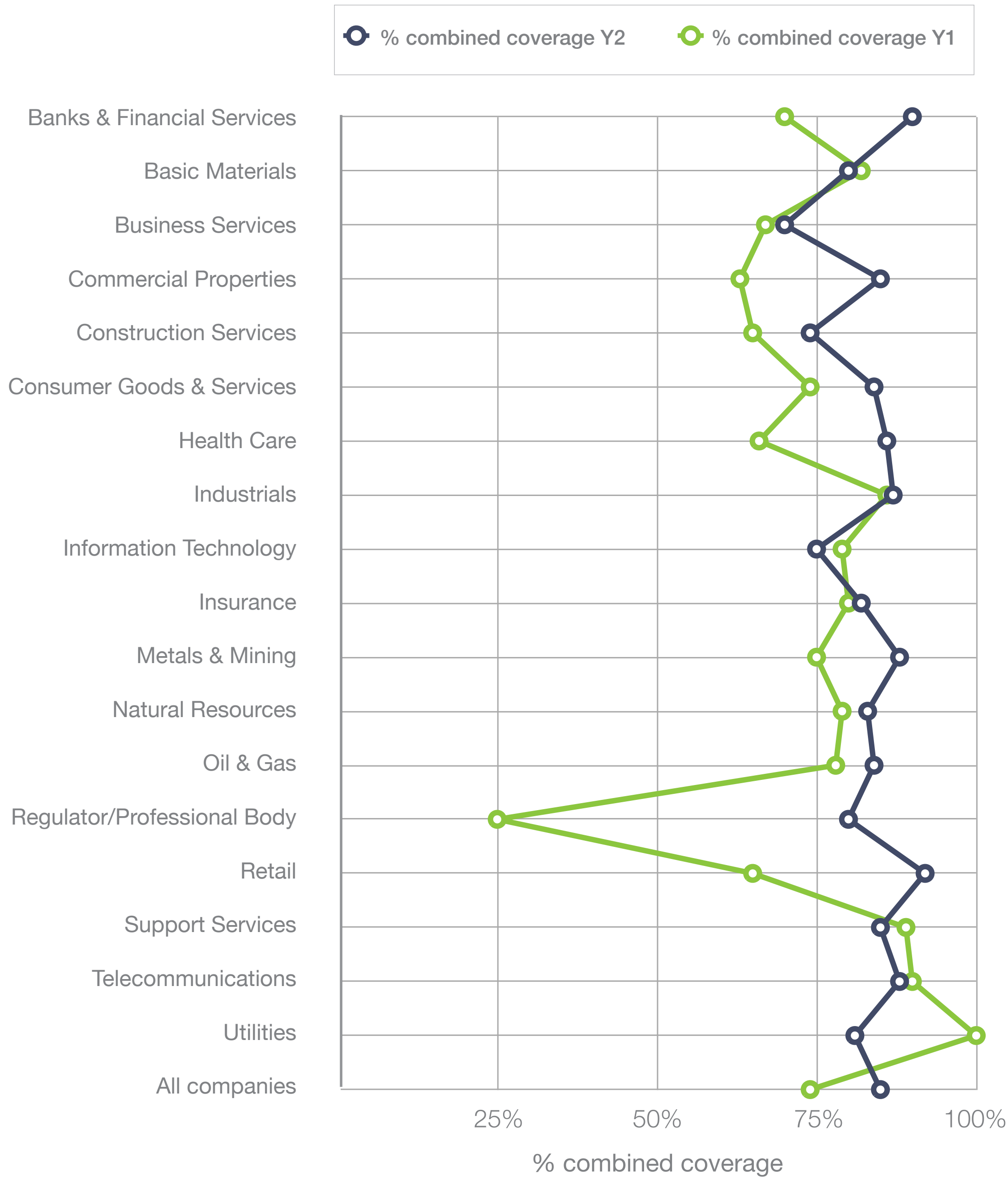
Table 13: Alignment between audit committee and auditor's reports

Sector	Average number of issues reported by Audit Committee per company in sector		Average number of total risks reported by auditors in sector		Average number of risks/issues reported by both auditor and Audit Committee in sector		% combined coverage	
	Year 2	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2	Year 1
Banks & Financial Services	3.9	4.4	3.3	4.0	3.5	3.1	90%	70%
Basic Materials	3.3	3.4	2.8	3.6	2.7	2.8	80%	82%
Business Services	5.0	6.0	3.5	4.0	3.5	4.0	70%	67%
Commercial Properties	4.3	3.8	3.5	3.6	3.7	2.4	85%	63%
Construction Services	3.8	3.4	3.3	2.8	2.8	2.2	74%	65%
Consumer Goods & Services	4.9	4.6	3.9	4.6	4.1	3.4	84%	74%
Health Care	4.5	5.0	3.7	3.8	3.9	3.3	86%	66%
Industrials	5.0	4.2	4.5	4.1	4.3	3.6	87%	86%
Information Technology	4.5	4.3	3.8	3.9	3.4	3.4	75%	79%
Insurance	4.2	4.1	3.8	4.5	3.5	3.3	82%	80%
Metals & Mining	5.5	6.0	4.8	4.5	4.8	4.5	88%	75%
Natural Resources	6.0	4.3	4.0	4.4	5.0	3.4	83%	79%
Oil & Gas	5.6	4.5	5.0	7.0	4.7	3.5	84%	78%
Regulator/Professional Body	2.5	4.0	2.5	3.0	2.0	1.0	80%	25%
Retail	4.1	5.1	4.0	4.7	3.8	3.3	92%	65%
Support Services	4.1	3.7	3.7	3.9	3.5	3.3	85%	89%
Telecommunications	5.7	4.2	5.3	5.4	5.0	3.8	88%	90%
Utilities	5.2	3.0	5.3	4.0	4.2	3.0	81%	100%
All companies	4.3	4.3	3.9	4.2	3.7	3.2	85%	74%
All companies	4.3	4.3	3.9	4.2	3.7	3.2	85%	74%

Source: ***FRC analysis***

The trend has also been for audit committee reports and auditor's reports to align more closely on the specifics of issues identified, even where those issues are being described differently. [see graph 10 below] This is perhaps unsurprising as these combined changes have become embedded, and the preparers of both sets of reports develop a greater sense of what to expect from the other.

Graph 10: Combined Coverage of significant issue



Source: ***FRC analysis***

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The graph shows that since year one there has been an increasing overlap between issues reported by both auditor and audit committee. In year one c. 74% of the issues included in audit committee reports for all companies in our sample were also included in auditor's reports, which increased to 85% in year two. At the same time, 76% of the risks identified by auditors were also included in audit committee reports in year one, rising to 95% in year two.

Qualitative Assessment

In our report last year we found that 90% of our sample of auditor's reports complemented the Audit Committee Reports well. This was based on a subjective assessment made during our review, and went beyond a matching of risks. The aim was to take a view on whether there was consistency in the 'story' being told and the way in which the risks were evaluated and concluded on. In the current year this percentage has risen to 97%, or 271 of the reports we reviewed.

One risk which may arise from this close alignment is the repetition of information between the auditor's report and the audit committee report – particularly where 'significant issues' in the audit committee report are essentially the same, and the descriptions of outcomes largely identical. This risk does not crystallise where the reports focus on the same issue but from a different perspective, with one potentially adding value to another. As an example, the auditors of Weir Group PLC reported on impairment risks relating to the carrying value of goodwill and intangible assets, and specifically in respect of management assumptions about one of the Cash Generating Units (CGUs):

> *"For the Pressure Control and Pressure Pumping CGUs, given the near-term lower oil price environment, we focussed on the projected cash flows for these businesses under a range of oil price assumptions in the short and long terms, including scenarios generated from external analyst reports and internal EY economic projections." [EY, Weir Group PLC Independent Auditor's Report, p/e 2 January 2015]*

The equivalent reporting from the audit committee was:

> *Specifically in relation to Pressure Control, we have discussed the cash flow forecasts underpinning the impairment test with management to understand the main assumptions around macroeconomic factors, volume/price effect and any strategic initiatives. We agreed that the assumption of the current oil price of around US$50 a barrel, and consequent activity levels, enduring for the next two years with a measured return to more 'normal' levels thereafter is the most appropriate one given what we know today. On that basis we agree with the best estimate impairment charge of £160m of the Pressure Control CGU and concur with its allocation against goodwill.*

With regard to Pressure Pumping, this business is more mature and had significant levels of headroom between net asset value and discounted cash flows going into the current market downturn. Management have included in their reporting to us the stress test scenarios that have been applied and we agreed, following a detailed review, that no impairment charge is required…. [Weir Group PLC Annual Report and Accounts 2014, Report of the Audit Committee]

In this case the user of the financial statements clearly benefits from the two separate reports – one of which provides information about the audit approach, including the use of internal EY projections, and the other describes the detailed scrutiny of management's assumptions by the audit committee.

The auditors of SERCO, as a further example, included an Emphasis of Matter paragraph because although they concluded that the use of the going concern basis of accounting was appropriate they identified a material uncertainty in respect of a potential breach of loan covenants:

"As described in the note 2 to the financial statements the Group is in the process of re-financing its debt facilities and seeking approval to raise approximately £555m by way of a fully underwritten rights issue. The completion of the rights issue is dependent on approval from the shareholders of the Company, which at the time of issuing these financial statements has not yet been obtained. If the proposed rights issue is not approved, the Group is forecast to breach the Covenants in its loan facilities which, in the absence of a waiver, would result in all of the Group's debt facilities becoming repayable on demand. In this event, the Group does not anticipate that it would have the funds available to repay such amounts at that time, and would need to take alternative steps in order to be able to continue as a going concern.

Whilst we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate, these conditions indicate the existence of a material uncertainty which may give rise to significant doubt over the Group's ability to continue as a going concern….Our opinion is not modified in respect of this matter." [Deloitte Independent Auditor's Report to the members of Serco Group PLC, for period ended 31st December 2014]

This has a matching disclosure in the Audit Committee Report which sets out the basis on which that committee also reviewed management's assertion on the going concern basis of accounting.

“Going concern

The Directors have acknowledged the guidance ‘Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009’ and ‘An update for Directors of Listed Companies: Responding to increased country and currency risk in financial reports’, published by the Financial Reporting Council in October 2009 and January 2012 respectively. This is discussed in the Finance Review on page 65.” [Audit Committee Report, Serco Group PLC annual report and accounts, for period ended 31st December 2014]

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Section 10: The Views of Investors – including The Investment Association Auditor Reporting Awards

In the course of preparing this report we have had several discussions with both individual and groups of investors, in order to get a sense of their views on progress made in the second year of extended auditor reporting. The investors we spoke to provided valuable insight into how they use auditor reports, what they value and what areas of improvement they would like to see.

Investor Feedback to the FRC

The consistent message we had from investors was that the quality of auditor reports was underpinned by an understanding and recognition of the needs of the primary users of financial statements. Investors value:

- A balance between insightful commentary and conciseness;
- Clear signposting of key issues;
- Logical structure and uncluttered presentation;
- Effective cross-referencing to relevant parts of the annual reports and financial statements;
- Information about the outcome of audit work rather than generic descriptions of process;
- Reports which avoid bland, generic or uninformative language; and
- A clear breakdown of the scope of the audit – including the extent of coverage by full scope, specified procedures or other group procedures.

The investors we spoke to also said that they would welcome:

- Further enhancements to disclosures around materiality, including the rationale for benchmarks selected. This was particularly an issue where adjusted profit measures were being used;
- Better explanations of how materiality practically impacts on the conduct of the audit, including error evaluation; and
- Clearer explanations about the level and quality of assurance derived from component audit teams.

More generally, and perhaps outside the scope of the auditor's report itself, some investors felt that auditors could still do more to explain some of the basic characteristics of their approach. This covered technical concepts such as performance materiality (see chapter x above) as well as how judgements are made about the balance between substantive procedures and controls reliance as a source of assurance.

Our review was restricted to reports produced for the largest companies in the UK. There is anecdotal evidence to suggest that the picture is less encouraging for smaller listed companies, and we had clear feedback that this is an area where many investors would like to see further improvements.

The Investment Association Auditor Awards

In producing this report we have also drawn extensively from the outcome of the second The Investment Association Auditor Reporting Awards which were presented in November 2015. The major audit firms submitted a shortlist of reports which they felt best met the requirements, which were then assessed by an independent judging panel.

There were nine awards in total, rewarding the best examples of disclosure of the key elements of the auditor's report: materiality, scope and risk of misstatement as well as an overall award. There were separate categories for FTSE 100, Other Premium Listed entities and for other entities where the auditor has adopted some or all of the new requirements even though not required to do so. A summary of the awards is included as Appendix 1 to this report.

Appendix 1: The Investment Association Awards Winners

The winners of each category, including the feedback provided at the event, are set out below. It is noticeable that the reasons why the panel made awards to these particular reports is consistent with the feedback we describe above.

One further point to note is that investors and other users of financial statements are not just looking for enhancements in particular technical disclosures about the audit. One obvious common characteristic of the majority of these winning reports – and one that should not be underestimated – is that they are presented in a visually appealing way. This means that they should be constructed with the end user in mind, with key information very well signposted, a clear and logical structure and they should make good use of diagrams and colour. These are not superficial aspects, since they relate directly to the way in which some of the primary users actually work with and extract value from these documents.

Materiality

FTSE 100: Direct Line Insurance Group plc, Deloitte LLP

- Disclosures were thought to be clear and logical, and provided real insight into the professional judgement used.
- The Report included an explanation of why materiality was lower than in the prior year.
- The calculation was well explained and compared to other benchmarks.

Other Premium Listed: UBM plc, Ernst & Young LLP

- The Report includes an overview highlighting the approach to materiality, and the explanation itself was clear and concise.
- Adjustments made in calculating materiality were set out, and performance materiality explained, together with the rationale for it decreasing in the current year.

Audit Scope

FTSE 100: BG Group plc, Ernst & Young LLP

- The report include a very clear diagrammatic presentation of scope.
- Consistent with some of the reports we discuss in our chapter on audit scope, the report sets out the approach to each component, including whether they were subject to full scope audit, specific procedures or other group audit work.
- The disclosures also make it easy for the user to identify the location of different components, as well as the overall audit coverage by percentage of pre-tax profit and assets.

Other Premium Listed: EVRAZ plc, Ernst & Young LLP

- As we have noted elsewhere within this report, the Evraz Auditor's Report is well designed, and clearly signposts each important element.
- Similar to the BG Group audit report, the award recognised the clarity of disclosure, including the coverage from full audit, specific procedures or other audit work.
- Changes since the previous year were highlighted.

Risk of Misstatement

FTSE 100: Rolls-Royce Holdings plc, KPMG LLP

- The Report included clear commentary on what had changed since the prior year.
- Overall it was thought to convey meaningful insights into the audit process, and particularly where the auditor had challenged management's assumptions and exercised professional scepticism.

Other Premium Listed: Intermediate Capital Group plc, Deloitte LLP

- We have noted elsewhere in our report that this was one of the few reports to include unambiguous results from testing of significant risks and to include adjustments arising from the audit. This level of transparent disclosure was recognised in the award.
- Once again this report included a description of changes since the prior year.

Overall

FTSE 100: Marks &Spencer Group plc, Deloitte LLP

- Considered to be very well laid out and easy to use from the investor perspective.

Other Premium Listed: EVRAZ plc, Ernst & Young LLP

- A very clear and easy to follow layout.
- Arrows indicating the changes in risk from the previous year.
- A clear summary at the beginning which included what had changed since the last audit.

Non Mandatory Adoption of requirements: Frimley Health NHS Foundation Trust, PricewaterhouseCoopers LLP

- This report was awarded for containing comprehensive risk disclosures, a strong explanation for changes in materiality and a good summary of audit scope.

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