Sharing the UK Experience Audience:

Implementing the enhanced auditor reporting

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Presentation outline

- Overview of the FRC
- The need for change
- Package of changes
- Objectives of changes
- Experience to date
- Common auditor pitfalls

Overview of the FRC

- FRC Mission
  - *to promote high quality corporate governance and reporting to foster investment*
- Supporting strategies of trustworthy information and trustworthy behaviour

Overview of the FRC (2)

FRC Scope

- Corporate governance and stewardship code
- Setting accounting, auditing and actuarial standards
- Overseeing the accountancy and actuarial professions
- Monitoring corporate reporting and audit quality
- Operating an independent disciplinary scheme

Overview of the FRC (3)

- Advantages of a broad scope
  - Feedback loop between setting and monitoring standards
  - Range of tools available
  - Sphere of influence

The need for change

- Financial crisis highlighted
  - The need for high quality audit
  - Relevance of audit
  - Lack of transparency
  - Investors expectation that auditors, boards and regulators work together more effectively to identify, assess, mitigate and report on risk
- Based on our audit inspections a need to raise quality generally

Package of changes

- Measures to enhance the management of risk and related corporate reporting
  - Setting out the business model
  - Explaining how risk is managed
  - Fair balanced and understandable
  - Greater transparency of the work of the Audit Committee
- Measures to enhance the relevance of audit
  - Extended scope of reporting across the annual report
  - Extended auditor reports
- Measures to enhance auditor objectivity and independence
  - More stringent ethical standards
  - Retendering

Overview of changes

Audit Committee Reporting

- Significant issues they considered and how they were addressed
- How they assessed the effectiveness of the external auditor
- Their approach to ensuring auditor independence

Changes designed to increase transparency and focus of both the auditor and audit committee on audit quality

Overview of changes (2)

Auditor Reporting

- A description of the assessed risks of material misstatement
- Their impact on audit strategy, resources and audit effort
- How the auditor applied the concept of materiality
- A summary of the audit scope and how it responded to the assessed risks and application of materiality

Overview of changes (3)

Auditor Reporting (continued)

- Changes designed to enable more informed dialogue and public challenge about whether audits meet the legitimate needs of users
- Auditors were encouraged to be entity specific and joined up with audit committees

Overview of changes (4)

Auditor Reporting (continued)

- Encouraged individual audit partners to be innovative
- No specific examples within the standard
- Materiality discussion <u>must</u> specify the threshold used for the financial statements as a whole
- Effective for financial years from October 2012 onwards

Overview of changes (5)

We met with some resistance

- Too much responsibility on audit committees
- Calls to delay until IAASB standard issued
- Insufficient guidance
- IAASB highly supportive

Experience to date

- Benefitted from early adoption by Vodafone
- Benefitted from good dialogue and interaction between all stakeholders
- Overwhelmingly positive
- Auditors surpassed expectations
- Differences between and within firms emerged

Investor feedback

- Generally positive as provides a basis for dialogue
- Citi Bank research September 2015
  - Year 2 an improvement
  - A need for greater clarity on materiality
  - Focus on specific rather than generic risks
  - More ‘Rolls-Royce’ style reports wanted
  - Disclosure of adjusted and unadjusted audit differences
  - Further innovation sought

First year experience

- New requirements: risk, materiality & scope
- Plus:
    - Going concern disclosures
    - Location of opinion within the audit report
    - Standard language use
    - Diagrams and graphs

Reporting of risks

- Survey found between 1 and 10 risks reported
- Average number higher for FTSE 100 companies
- Some included standard risk of material misstatement due to fraud and error, or management override of controls
- Most risks by industry sector in Oil & Gas and Telecoms
- Granular, specific risks (61% of sample) versus generic risks (39% of sample)

Materiality

- General requirement in ISA 700 to explain application of the concept of materiality, and specify the threshold used for the financial statements as a whole
- ISA 700 also suggests five further matters:

Matter suggested	Take up in sample (of 153)
Materiality for classes of transactions, where it is lower than materiality for the financial statements as a whole	Observed in 5 cases
Performance materiality	With some exceptions, largely by one firm only
Significant revisions	No examples found
Threshold for reporting unadjusted differences to the audit committee	Widespread disclosure
Significant qualitative considerations	No examples found

Scope

- Assessment of how well scope of audit addresses risks of material misstatement and application of materiality – 56% comprehensive, 24% met requirement, 20% did not fully meet the requirement
- Measures used:
  - Revenue coverage
  - Total asset coverage
  - Profit before tax
  - Use of auditor’s experts
  - Reference to component auditors

Going concern

- ISA 700 – report by exception on Listing Rules requirements on going concern
- 2 firms went further than the standards, providing a going concern section within the auditor's report
- Some examples of innovative extended disclosure

Location of auditor’s opinion

- ISA 700 did not change the positioning of the opinion, but some firms have reconfigured their opinions

Location of Opinion	Number	%
Located first – no introduction	93	61%
Located first after a brief introduction	41	27%
After scope of the audit, before paragraph 19A disclosures (per FRC guidance)	16	10%
End of audit report	3	2%
Total	153	100%

Standard language & diagrams and graphs

- Going beyond generic wording
- Clearer use of headings
- Cross referencing to other parts of the annual report
- Diagrams and graphs to disclose results, and represent assets and liabilities rather than just text

Year 2 experience

- The evidence suggests ongoing incremental improvements, some of which address the concerns or aspirations of investors
- Different firms have addressed different areas – there is no reversion to a pro-forma approach
- No significant or revolutionary change – more incremental
- Many more audit reports now set out the findings against significant risks
- Nearly all firms now place the opinion at the beginning of the report
- There were no cases where the benchmark for materiality was not disclosed – there was a small population of outliers in 2014

Audit committee reporting

- Looking for alignment between the report on the work of the audit committee and the auditor’s report
- Average correlation – auditor’s reported on 74% of the risks flagged by audit committees
- FRC concluded 90% of auditor’s reports in our sample aligned well with the report of the audit committee
- Greatest challenge for Audit Committees was how they considered the effectiveness of the audit
- Reporting of audit inspection findings

Common auditor pitfalls

As part of our routine inspections we noted a few teething problems

- Inaccurate or imprecise description of the work performed
  - Use of experts
  - Testing of controls
- Two examples where the scope could be misinterpreted