

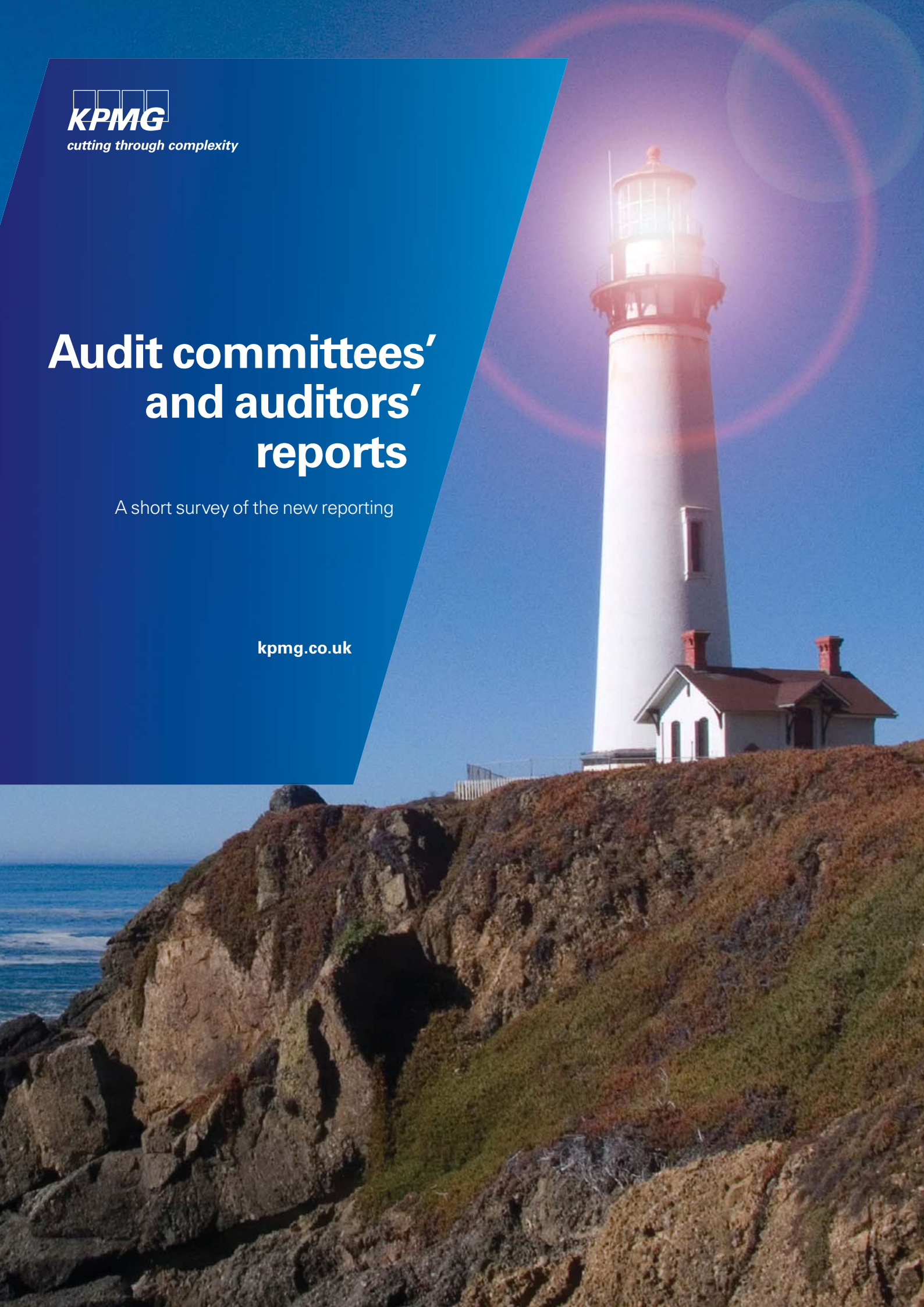


cutting through complexity

# Audit committees' and auditors' reports

A short survey of the new reporting

[kpmg.co.uk](http://kpmg.co.uk)







## FOREWORD



Since the financial crisis there has been much reflection about both corporate reporting and audit. Many wonder whether financial statements have lost their way; whether, when faced with a set of accounts today, shareholders find themselves unable to see the wood for the trees. At the same time the statutory audit is under pressure – rightly – to deliver more.

So I have a strong personal commitment to the new corporate and audit reporting that is being implemented right now. If you're an audit committee chair it means moving up a step to be open about the accounting issues – the things that really make a difference to the accounts – and how you and your fellow committee members dealt with them. If, like me, you're an auditor, it's about moving beyond the binary opinion, to lift the lid, explain what you saw as the issues and what you did about them. By seeing inside the work of the audit committee and the auditor, shareholders should get more of the insight that they need.

A practical challenge is that the regulators didn't give these reforms a long lead time. However, I enjoy a challenge. So I am pleased to see that our survey finds some very good examples of a step change in reporting. It also shows that there can be quite some variation in depth and colour. Perhaps this is only to be expected with an overnight revolution in reporting, and I trust that we shall see consensus practice quickly develop around the best examples.

I hope that investors, audit committees and their companies find this survey useful. It's still early days for these reforms but it's vital that we do them well. They are about helping to restore trust to the stewardship relationship between investors and companies and with audit playing its vital part in that. At KPMG we certainly believe in the value of our opinion for shareholders and we are committed to putting that into practice in our reports.

### **Tony Cates**

Head of Audit  
KPMG in the UK

21 January 2014

- > For periods beginning on or after 1 October 2012 the Corporate Governance Code<sup>1</sup> ("the Code") requires companies to explain how their audit committees addressed the key accounting issues.
- > At the same time a revised auditing standard<sup>2</sup> requires the auditor to give a long-form audit report, e.g., setting out what they thought were the most significant risks and how they addressed them through their audit.
- > In doing so the Financial Reporting Council (FRC) is asking for a step change in transparency around accounting and auditing issues. Certainly it is the most significant change to audit reporting in decades.

# *What* **we** SURVEYED

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<sup>1</sup> [www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf](http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf)

<sup>2</sup> [www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-\(UK-and-Ireland\)-700-\(Revised\)-File.pdf](http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-(UK-and-Ireland)-700-(Revised)-File.pdf)

Surveyed companies by sector



- > By early January 2014, 19 FTSE 350 companies had published annual reports within this new regime.
- > In addition to these 19, there were three FTSE 350 investment companies. These all feature similar risks in the limited area of investment valuation. This specialised sub-set of the FTSE 350 are left out of this survey.
- > The four grouped as 'other' cover a range of sectors, from telecoms to mining.

# Audit Committee reporting

# WHAT

# has changed?

Compliance with the revised Code requires greater disclosure of how the audit committee discharged its duties.

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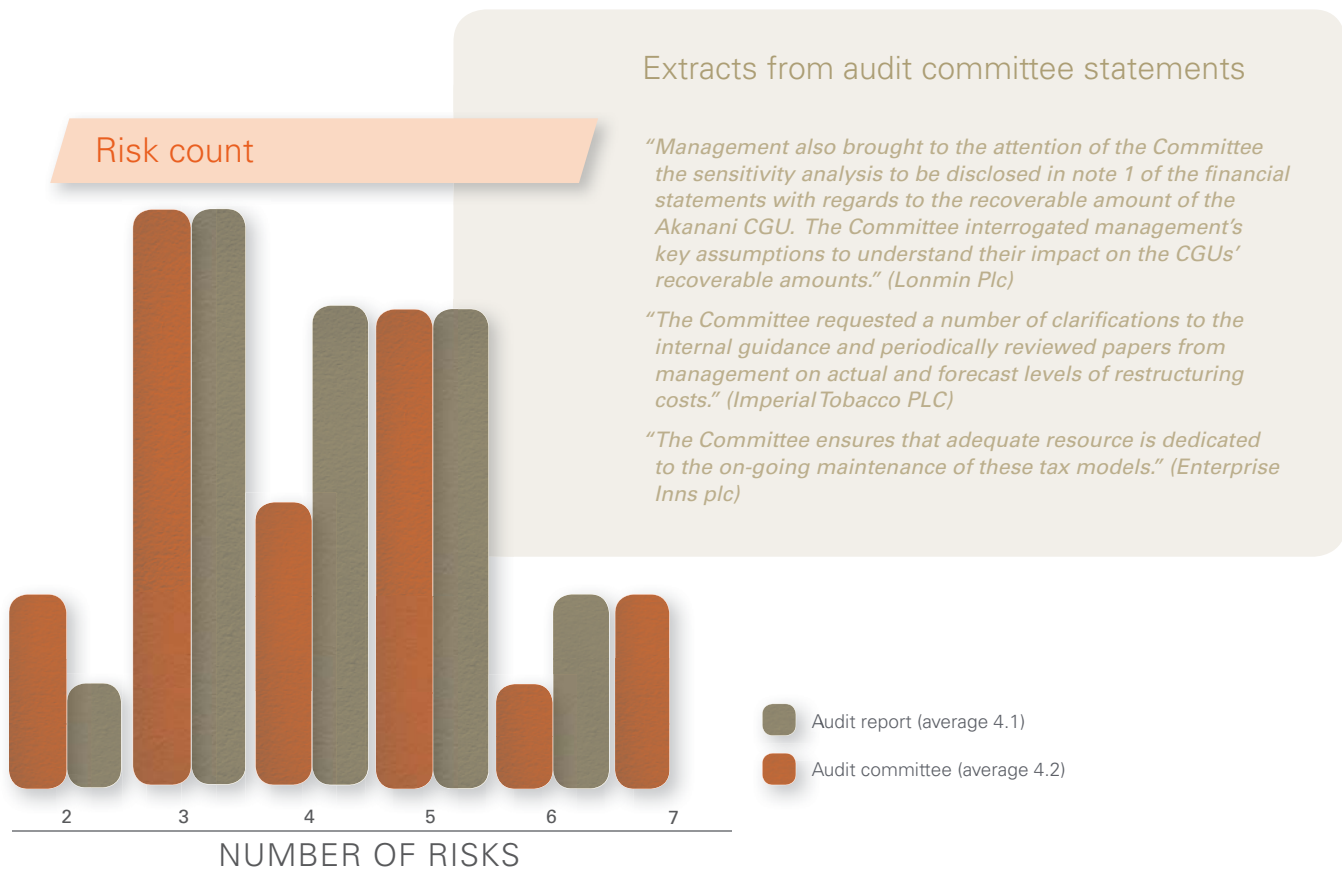
A separate section of the Annual Report should describe ... the significant issues considered by the committee in relation to the financial statements, and how those issues were addressed. (Code Provision C.3.8)

The FRC's Financial Reporting Lab<sup>3</sup> notes that investors value disclosure that:

- ✓ quantifies the risk;
- ✓ identifies the related product, business or geographical area affected;
- ✓ makes clear how the committee satisfied itself as to the appropriateness of the work done by management;
- ✓ gives a clear indication of the committee's conclusions;
- ✓ explains the key factors considered by the committee;
- ✓ refers to the sources of evidence considered by the committee;
- ✓ cross refers to the related financial information in the accounts; and
- ✓ uses active rather than passive language.

<sup>3</sup> Lab project report: Reporting of Audit Committees

[www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Reporting-of-Audit-Committees.pdf](http://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Reporting-of-Audit-Committees.pdf)



## HOW ARE AUDIT COMMITTEES RESPONDING?

The Lab’s suggestions seem, so far, to have met with mixed take-up. Some contain detailed, specific narrative on an issue-by-issue basis in terms that show an active audit committee. This commonly includes a description of the key factors considered, the sources of that evidence and the conclusions reached by the audit committee. See, for example, Lonmin Plc, Imperial Tobacco PLC and Enterprise Inns plc.

Others are less specific, describing the issues focussed on, but being much less forthcoming as to *how* the audit committee satisfied itself that the issue – whether one of judgment about accounting treatment or one of a difficult accounting estimate – was appropriately dealt with in the financial statements.

The risk is that these different approaches will give the impression of different styles of audit committee: from one whose oversight is more active and engaged to one which appears to be confined to receiving and reviewing reports from management. This is an area where we expect that reporting practice will develop further.

## HOW MANY ISSUES ARE THEY COVERING?

The number of issues disclosed by audit committees showed some wide variation from two to seven. We doubt that this wide spread reflects differing application of the new disclosure among audit committees. It is more likely to reflect the fact that some sectors and business models are open to more, and to some to fewer, issues.

Although the averages for audit committees and audit reports look similar, we found that audit reports include some risks that audit committees do not. All of these are due to the auditor’s including risks deemed by auditing standards always to be significant; we comment on that on page 8.

At the same time, some audit committees include issues that auditor does not cover. At this early stage it is difficult to know why this is so.

Perhaps, given the relatively short disclosures from audit committees so far, they feel that it would not lengthen the statement by much to include the less significant issues too. If so it would be helpful if audit committees flagged the distinction between the significant and the other issues, so as to avoid it appearing as if the committee and the auditor disagree as to what is significant. Some, though surprisingly not all, relevant audit committee statements did this.

## *Audit reports*

# WHAT has changed?

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As a companion to the Code's changes, auditing standards now require the following from the audit report:

- ✓ a description of the key audit risks;
- ✓ an explanation of the concept of materiality in planning and performing the audit; and
- ✓ an overview of the scope of the audit, including explaining how the auditor addressed the key audit risks and how materiality influenced the scope of the audit.

“““

The provision of a fuller description of the work the auditor has undertaken will give far more insight to investors than the binary pass/ fail model of the current audit report. (Nick Land, Chairman FRC Audit and Assurance Council, press release on the new auditing standard)





## RESTRUCTURING THE REPORT

These changes introduce much extra text into the report. Most auditors have taken this as an opportunity to re-order the whole audit report to bring the opinion right up-front to the beginning of the report. We have done this with our reports, then immediately following the opinion we have our explanation of the risks etc; we trust that this will make it easier for shareholders to focus on the opinion and the key risks that were addressed in arriving at that opinion, together with the work to address those risks.

The extra text introduced by these reforms is specific to the particular audit, and in our reports we have also taken the opportunity to place much of the long-standing, standardised, generic text on our website and to incorporate that into our reports by web-link cross-reference (see for example, Lonmin Plc).



## WHAT RISKS ARE COVERED?

This is perhaps the most noticeable change in audit reporting, moving away from the old, binary model of either a 'clean' or 'modified' audit opinion and giving shareholders information on the focus areas of the audit. This is a step change, and we believe it is a positive one.

So what type of risks are being reported? The top one is goodwill impairment – perhaps no surprise, given the economic climate and the inherent subjectivity involved in forecasting and discounting future cash flows.

The next two top risks, management override of controls and fraud in revenue – are included because they are deemed always to be significant by ISA 240<sup>4</sup>. However, it is not clear to us that they will *always* be risks with the greatest effect on audit strategy or the efforts of the engagement team. For this reason we do not anticipate seeing these risks included in our audit reports as a matter of course.

The next most frequent risks are revenue recognition and pension accounting – areas where commonly there is a greater degree of interpretation of accounting standards, management judgement or estimation involved.

The largest population – covering more than one third of the risks – is 'other', covering a wide range from, for example, valuation of contingent consideration in an acquisition to aircraft maintenance provisions. We believe that breadth should be seen as a positive. It means that reports are covering the real issues, specific to the individual companies, and not some set of generic 'usual suspects'.

““““

The auditor's report shall ... describe the assessed risks of 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 ... [and] an explanation of how [the audit] addressed the assessed risks of material misstatement (ISA 700.19A)

<sup>4</sup> ISA (UK & Ireland) 240 *The auditor's responsibilities relating to fraud in an audit of financial statements*  
[www.frc.org.uk/Our-Work/Publications/APB/240-The-auditor-s-responsibility-to-consider-fraud.aspx](http://www.frc.org.uk/Our-Work/Publications/APB/240-The-auditor-s-responsibility-to-consider-fraud.aspx)



## Audit report extract

*“Certain of the key inputs, specifically mineral resource, discount rate, PGM prices, capital and operating costs, inflation, exchange rates, and sales terms, require significant estimation and judgement in their selection, and can have a significant impact on the derived NPV. For these key inputs we critically assessed the reasonableness of the Directors’ assumptions by reference to external data and forecasts, along with reports from the group’s external consultants. We utilised our own valuation specialists and engineers to the extent necessary in performing our work. We considered the adequacy of the group’s disclosures (see Notes 1, 10 and 11) in respect of impairment testing, and whether disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions properly reflected the risks inherent in the valuations.”*

*(KPMG Audit Plc, report to Lonmin Plc shareholders)*

## HOW ARE THE RISKS AND AUDIT WORK EXPLAINED?

In our view, this is the most important part of the new reporting. Investors no longer want to take it on trust that auditors have done appropriate work; auditors are, in effect, now being asked to say why they saw something as a risk, what work they did on it and the evidence they sought to satisfy themselves, and to show the independence and scepticism in their approach.

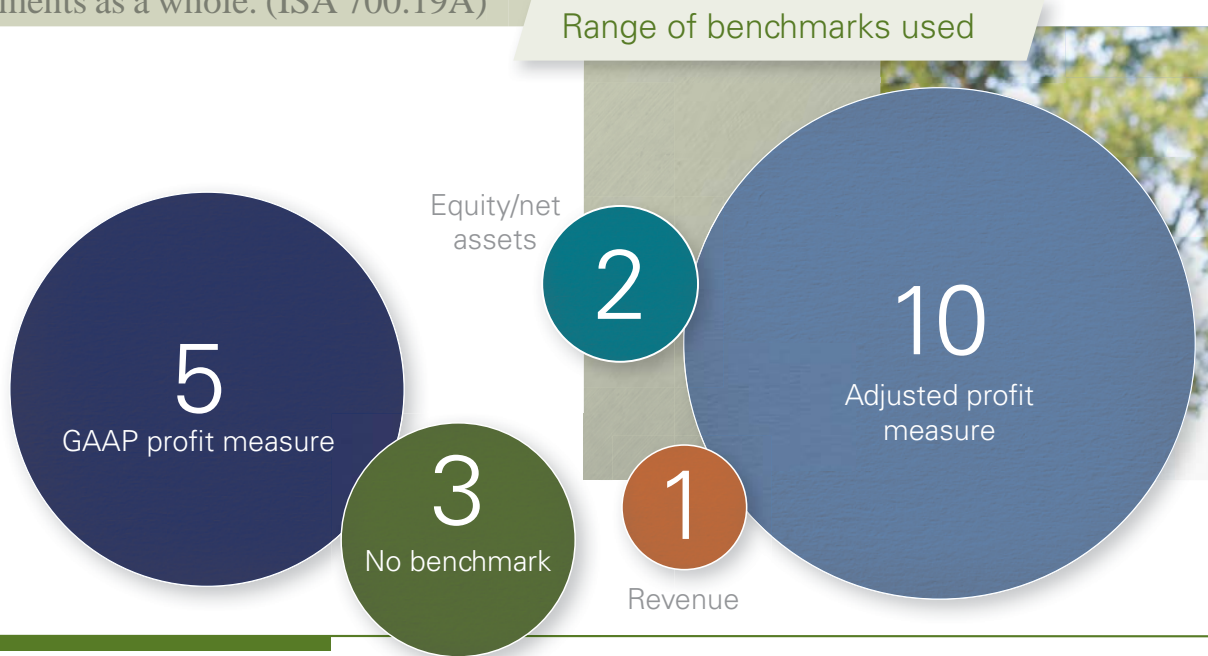
At this early stage, however, the level of detail in the descriptions varies: from statements that testing has been done, to statements that challenges have been made to management’s assumptions and estimates, to an overview of the basis of those challenges. We believe that the latter approach is the better one, and it is the goal that we have set for our own audit reports. Giving this information will not only help shareholders understand what the auditor does, but we also see it as part of restoring trust in financial reporting – in the stewardship relationship between investors and companies.

Some reports also cover the audit work on disclosure where the risk relates to subjective estimates. After all, in such cases disclosure about sensitivity of estimates can be an important part of the financial statements.

In terms of format, many reports place each risk description together with the description of the audit approach to it. However, a minority of our sample keep these separate, explaining the auditor’s response as part of their explanation of the scope of the audit.



The auditor's report shall ... provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole. (ISA 700.19A)



## BEING OPEN ABOUT MATERIALITY

The role of materiality in an audit is perhaps unlikely to be widely understood outside of the profession, so virtually all reports, in addition to giving the required figure for materiality, gave an explanation of the role and function of materiality in an audit (we include ours via the link to our website). In addition, all examples included the threshold for reporting errors to the audit committee.

Materiality for the financial statements as a whole is determined in the light of a 'benchmark' – a figure (or figures) from the financial statements that are used as a representation of the main area of focus of shareholders in the financial statements. Almost all reports describe the benchmark used (and two include multiple benchmarks).

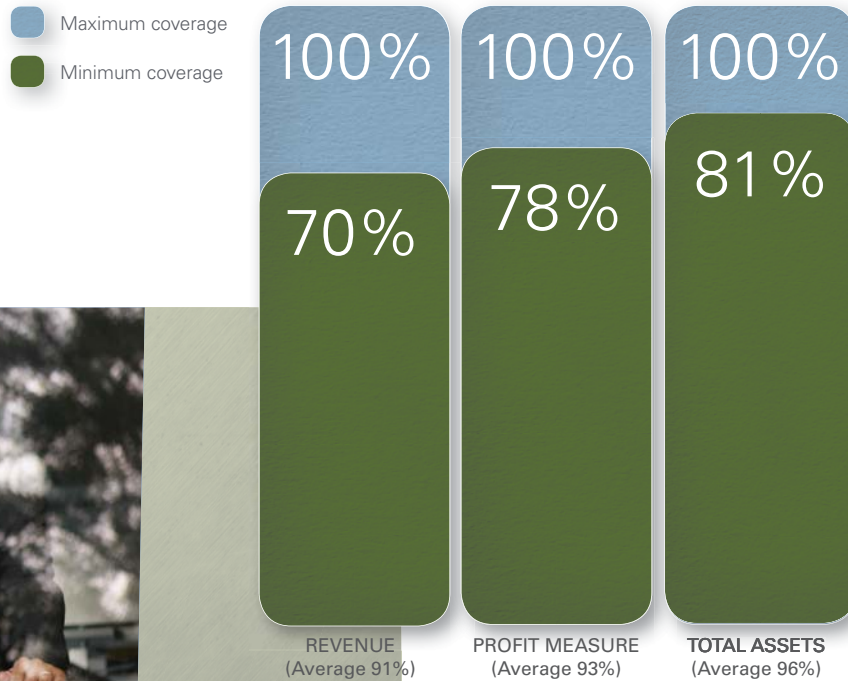
Profit is widely regarded as the usual benchmark in auditing and so it is no surprise that this dominates. Expressed as a percentage of the benchmark, the materiality figures range from 4%-5.7% of adjusted profit measures and 5%-7.9% of GAAP profit measures.

The use of adjusted profit benchmarks has recently attracted regulatory focus. In December 2013 the FRC published a reminder<sup>5</sup> that whilst profit before tax can be adjusted ('normalised') to remove the effects of circumstances leading to exceptional increases or decreases in profit, it cannot be adjusted for recurring items – the FRC gives amortisation of intangibles as an example. The FRC's comments may lead to changes in the way adjusted profit measures may apparently be being used as materiality benchmarks.

In terms of other benchmarks, revenue is sometimes used as the starting point where, for example, profits are highly variable from year to year. This gives a more consistent measure. For asset-based businesses, net assets (or equity) is sometimes used, as shown by these results. Naturally, the range of materiality percentages extends to much lower figures for these benchmarks (0.9%-5%).

<sup>5</sup> Audit Quality Thematic Review: Materiality  
[www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Materiality.pdf](http://www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Materiality.pdf)





Audit coverage

## AUDIT SCOPE – COVERAGE OF OPERATING UNITS ETC.

A majority of our survey (14 of the 19) include numerical information on the extent to which the population of the group's constituent parts (operating units etc.), known as 'reporting components', have been subject to audit work whether by full scope audits of components or limited scope procedures. The coverage is quantified by giving the percentage of key financial statements line items, such as revenue, profit and total or net assets, accounted for by components that have been subject to such procedures.

This kind of information is already privately reported to an audit committee at the commencement of an audit. Now, however, audit committees will be able to compare coverage figures. It is possible that this will result in some 'levelling up', if audit committees request additional audit work to increase coverage to that of their peers. This could be an interesting area to monitor.

Often auditors are supplementing this data with figures for the materiality (usually, range of materiality) used in audit work at components and in many cases are distinguishing between component audit work done directly by the group audit team itself and that done by teams instructed by the group audit team.



The auditor's report shall ... provide an overview of the scope of the audit, including an explanation of how such scope ... was influenced by the auditor's application of materiality ... (ISA 700.19A)

# COMPANIES surveyed

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- > Ashmore Group plc
- > British Sky Broadcasting Group plc
- > Britvic plc
- > Diploma PLC
- > easyJet plc
- > Enterprise Inns plc
- > Grainger plc
- > Greencore Group plc
- > Imperial Tobacco PLC
- > ITE Group plc
- > Lonmin Plc
- > Marston's PLC
- > Mitchells & Butlers plc
- > Paragon Group of Companies PLC
- > Sage Group plc
- > Thomas Cook Group plc
- > UDG Healthcare plc
- > Victrex plc
- > Vodafone Group Plc



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## Contact us

If you would like to discuss this further please talk to your usual KPMG contact or contact:

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More information is also available from:

**KPMG's Restoring Trust website**

[www.kpmg.com/uk/en/topics/corporate-reporting/pages/default.aspx](http://www.kpmg.com/uk/en/topics/corporate-reporting/pages/default.aspx)

**UK Audit Committee Institute**

[www.kpmg.co.uk/aci/](http://www.kpmg.co.uk/aci/)

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Oliver Marketing for KPMG | OM010177A V2 | January 2014