



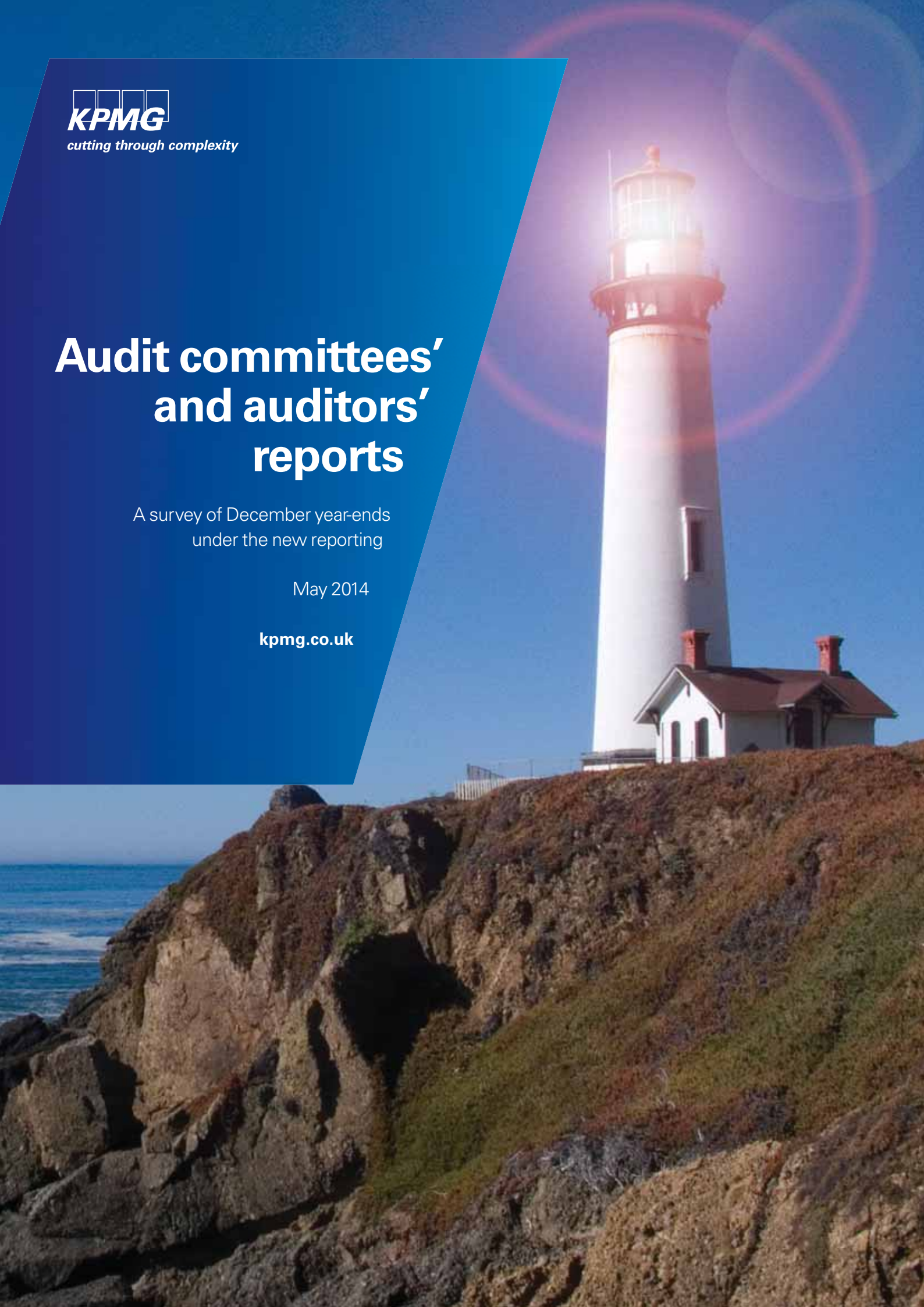
cutting through complexity

Audit committees' and auditors' reports

A survey of December year-ends
under the new reporting

May 2014

kpmg.co.uk





Foreword



As long-term investors, the belief that effective stewardship benefits companies, investors and the economy as a whole is core to our investment philosophy and approach. Well-governed companies are better positioned to manage the risks and challenges inherent in business and are better able to capture opportunities that help deliver sustainable growth and returns.

Amongst the many changes to corporate reporting this year, enhancements to audit committee and auditor reporting, have been quietly but keenly anticipated. The purpose of these reports in framing and communicating the focus, quality and relevance of the work done by audit committees and auditors is significant to us as shareholders.

While we are clearly at a very early stage in the development of this enhanced reporting, we have been pleasantly surprised by the usefulness of some of the disclosures. We are seeing audit committee and auditor reports being actively circulated and discussed amongst shareholders as part of the normal review and discussion regarding companies. But there is more to this than just an annual due diligence review. There is a strong subjective element in how we, as shareholders, assess the stewardship of a business and the quality of its reporting and auditing, and these reports provide an important medium that can contribute to that. In a world that is rarely black or white, they also help underpin the credibility and trust that needs to be inherent in the relationship between the leadership of a company and its shareholders.

The example shown by those who have embraced the purpose and intent of the new disclosure requirements is very welcome. There are, though, still cases where reporting has remained bland and more reflective of a boilerplate approach, leaving investors asking questions. I hope that all audit committee members and auditors will take a keen interest in the examples of emerging good practice that have been seen. I also welcome this timely survey and the observations and points that it highlights. These echo many of our own views about what we have seen and the challenges and characteristics of good practice that can make a real difference.

The lessons that can be drawn from this survey will assist us all in developing a sound and practical basis of understanding and dialogue between companies, auditors and their shareholders. It's a challenge we hope that all companies and auditors will embrace.

Iain Richards

Head of Governance and Responsible Investment
Threadneedle Asset Management

29 May 2014

Welcome to this survey



Audit committees and auditors have been busy with the challenges of the new reporting. Has it been worth it? Absolutely, yes. Take audit reports: for the first time in my career, they actually say something and are actually being read. I've been really pleased to hear, first hand, of the interest shown by the investment community, showing that we are moving in the right direction. The FRC should take the credit for its bold decision to set us off down that path.

Just how well are companies and auditors moving along that path, and where might it lead? That is what we look at in this survey.

The picture is broadly similar to the early indications in our January survey of the first few reports. There continues to be variety in the style and depth of audit committee statements, though we recognise that they are difficult to draft. The best examples show how the committee has been pro-active on behalf of shareholders. It's also good to see a broad range of issues being reported by audit committees and auditors, although not always the same issues.

We have also seen continued variety of depth in auditors' descriptions of the risks and audit work. We set out contrasting examples and explain the approach that we have taken to deliver the value of audit through our reports. We also look at the wealth of materiality data now available. That may attract questions and drive auditors to explain our approaches a little better but might also spark a debate about the norms for materiality – if so, we trust that the FRC would facilitate and lead that.

What about the way forward? At KPMG we believe in promoting debate about the future. So we have issued a small number of reports that go beyond the minimum, by also setting out what we found on each audit issue. Since then the new EC Audit Reform Regulation seems likely to drive reporting in that direction, and I hope to see the FRC taking forward the question of reporting findings: does that Regulation require it, and, if not, is there a consensus, of shareholders and companies, for it to become standard UK practice anyway?

I hope that investors, audit committees and companies find this survey useful; in particular, that it helps you to engage with the profession and tell us how we can improve and what might be the next stage in the journey; because at KPMG we believe in the value of audit and are committed to making it apparent in our reports.

Tony Cates

Head of Audit
KPMG in the UK
29 May 2014

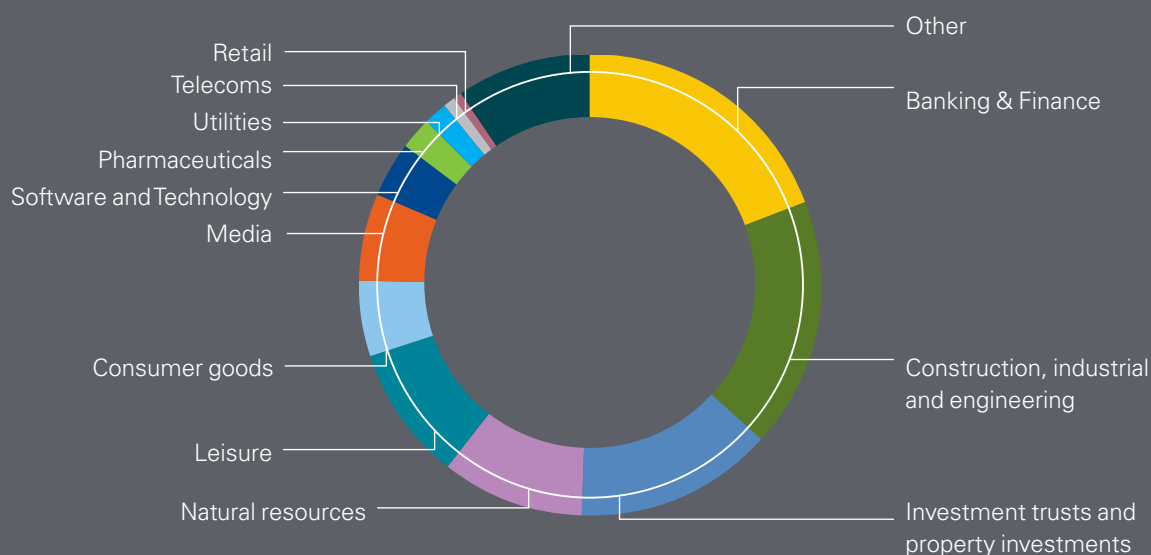
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What we surveyed



Surveyed companies by sector



- For periods beginning on or after 1 October 2012 the Corporate Governance Code¹ ("the Code") requires companies to disclose how their audit committees addressed the key accounting issues (or to explain why they make no such disclosure).
- At the same time a revised auditing standard² requires the auditor to give a long-form audit report, eg setting out what they thought were the most significant risks and how they addressed them through their audit.
- Unsurprisingly, given the number of banking and insurance companies listed in the UK, financial services is the single largest sector within our sample. There is also a large number of investment companies (primarily investment trusts and investment property companies). Our sector described as "other" represents a combination of outsourcing, facilities management and support services entities.

¹The UK Corporate Governance Code, September 2012
www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf

² International Standard on Auditing (UK and Ireland) 700 The independent auditor's report on financial statements, June 2013
[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)



Our survey looks at the published annual reports within the FTSE 350. At the time of writing, we have analysed 134 annual reports.

FTSE 350 by year-end	Published	Not yet published	Total
Early adopters	3	0	3
Pre-December 2013 year ends	30	0	30
December year ends	100*	92	192
2014 year ends	1	124	125
	134	216	350

*Four companies within our survey apply the 2012 Code but their non-UK auditors apply the international versions of auditing standards and so do not produce a long-form audit report. These companies are excluded from the remainder of our survey.



- We noticed a wide variation in the time taken by companies to publish their annual reports.
- The Companies Act³ requires that the annual accounts be made available on a website “as soon as reasonably practicable”. So we decided to investigate how long companies took. We looked at the period between the date of the accounts/ audit report and of the company’s RNS announcement of the website publication of their annual report. It averaged 20 days, but there was a wide range – 12 companies announced and published on the same day and 23 companies took more than 30 days, with one taking 78 days.
- In addition, we found 7 companies did not make an RNS announcement publicising their annual report. DTR 6.3.5R⁴ requires an announcement of the annual financial report and that announcement must include “an indication of which website the [annual financial report] is available.”

³ For example, s430(1)(a) and (4)(a)
<http://www.legislation.gov.uk/ukpga/2006/46/section/430>

⁴ FCA and PRA Handbook
<http://fshandbook.info/FS/html/handbook/DTR/6/3>

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12 companies announced and published on the same day and 23 companies took more than 30 days, with one taking 78 days



An expanded report from audit committees

The challenge for audit committees

The audit committee's additional responsibility is, when put at its simplest, to explain how it became comfortable with the key judgments made by management. There is no single or mandated way to do this. The basic problem, though, is perhaps one of resource. Whereas auditors have capacity for many thousands of man hours to be directed towards the challenges of complex systems, accounting and reporting requirements, an audit committee does not. It is necessarily reliant on management to produce information, and so the committee needs to define and target what it wants to see in order to have its own view as to where the issues might lie and to have the data to enable it to make a constructive challenge to the key judgments. We think this task is made easier if the company has an internal audit function.

How are audit committees responding?

We rated the audit committee statements according to how well each one exemplified the qualities that the FRC's Financial Reporting Lab⁵ have said would be valued by investors (see heat map). These ratings are, of course, subjective, but do facilitate some general observations.

First, consistently with our earlier survey⁶, we found a range of approaches, as shown by the spread of ratings that we gave to reports. Some audit committees produced detailed narrative, outlining what the key risks were, why they were an issue for the company, the evidence they considered and how the committees reached their conclusions – in particular showing that they were pro-active, for example in seeking information from management and not just reacting to what was provided to them. In our view, this is best practice, and we have shown extracts from some of those reports on page 12.

In contrast, a number of audit committees were less forthcoming in these more judgemental areas – stating their reliance on management's views but not providing further explanation.

The risk is that these different approaches will give the impression of different styles of audit committee, ranging from those that are more active and engaged to those with a more passive style. That passive style of reporting could give the impression of a passive style of audit committee.

In our earlier survey we said we expected reporting practice to develop further in this area. We believe it is still too early to draw conclusions – after all, our survey represents approximately one third of the FTSE 350 – and we believe that some

audit committees may revisit their approaches after comparing themselves with their peers. Moreover, if investors use this new narrative reporting as a starting point for greater engagement with boards and audit committees, this could be a catalyst for renewed interest in the role of the audit committee and the nature of the oversight they provide.

Finally on qualitative aspects, we found no marked change in the average across the FTSE 350. So although the same comments regarding passive reporting apply across both the FTSE 100 and 250, some of the best examples also come from the latter group.

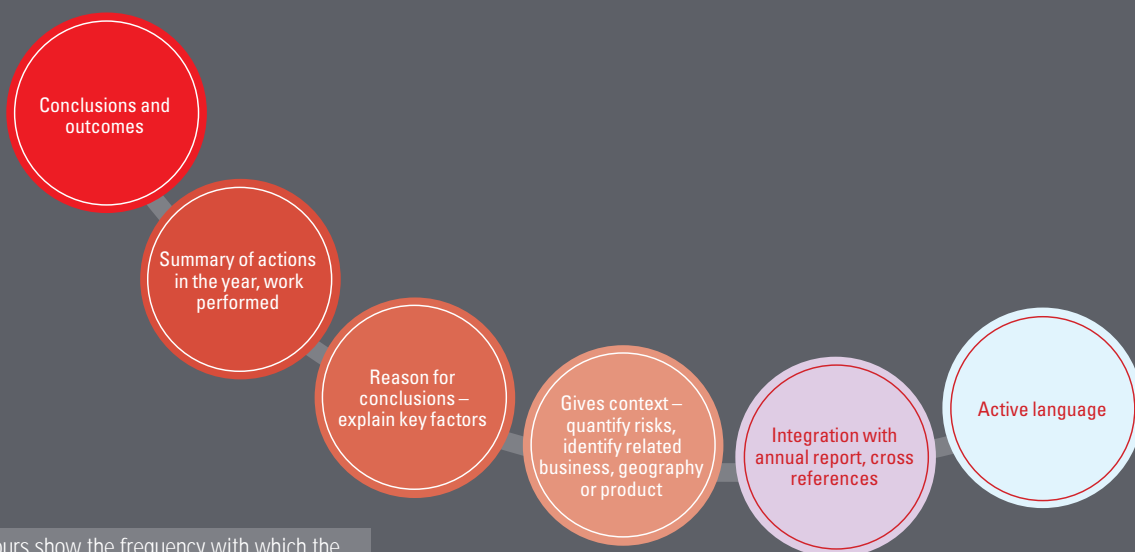
⁵ FRC project report: Reporting of Audit Committees, October 2013 www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Reporting-of-Audit-Committees.pdf

⁶ Audit committees' and auditors' reports: A short survey of the new reporting www.kpmg.com/channelislands/en/IssuesAndInsights/ArticlesPublications/Documents/Audit_committees_and_auditors_reports-Jan-2014.pdf

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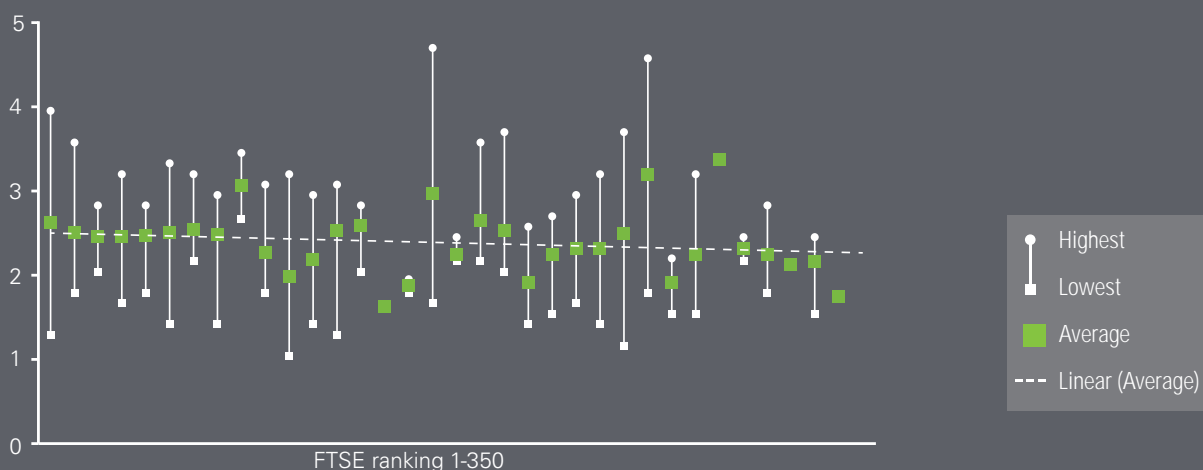
Financial Reporting Lab's factors - heat map



The colours show the frequency with which the factor is present in audit committee reports (red being most frequent).

Rating audit committee reports

We used the Financial Reporting Lab's criteria to "score" each statement on a scale of 0 to 5. We have shown the average score for each band of ten FTSE places and the highest and lowest score within that band; the line shows the average score falling off slightly, but we doubt that this is statistically significant.



Audit committee statement extract

"Impairment of loans and advances; ... Through the year, the Committee requested and received information on specific names and industries based on its assessment of the external environment, developments in footprint markets and areas identified in discussions with the Board Risk Committee. There is some common membership across the Audit Committee and the Board Risk Committee and this ensures that, in addition to an assessment of current adequacy of provisions, the Committee is also afforded a forward-looking view on potential risks and their impact. The Committee also receives reports from the management at each reporting period, detailing, inter alia, the composition of the loan book, provisioning levels and cover ratio by business and the judgment exercised around the individual and portfolio impairment provisions ... the Committee has discussed impairment with the management and the auditors and considers the provisions held within both the WB and CB businesses to be appropriate."

(Standard Chartered PLC)

Audit committee statement extract

"The independent external valuers presented the half-year and year-end valuations to the Committee. The Committee reviewed the methodology and component parts of the valuations, discussed the valuations with the external auditors and challenged the valuers on the assumptions used which included how land assembly transactions with Network Rail and Transport for London should be reflected. The Committee also advised the Board on the independence of the valuers and obtained confirmation that management had provided all requested information. The Committee was satisfied that the approach taken by the valuers was appropriate. Please refer to note 18 on pages 106 to 108 in the notes to the accounts."

(Capital & Counties Properties PLC)

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We found a range of approaches, as shown by the spread of ratings that we gave to reports

How many issues?

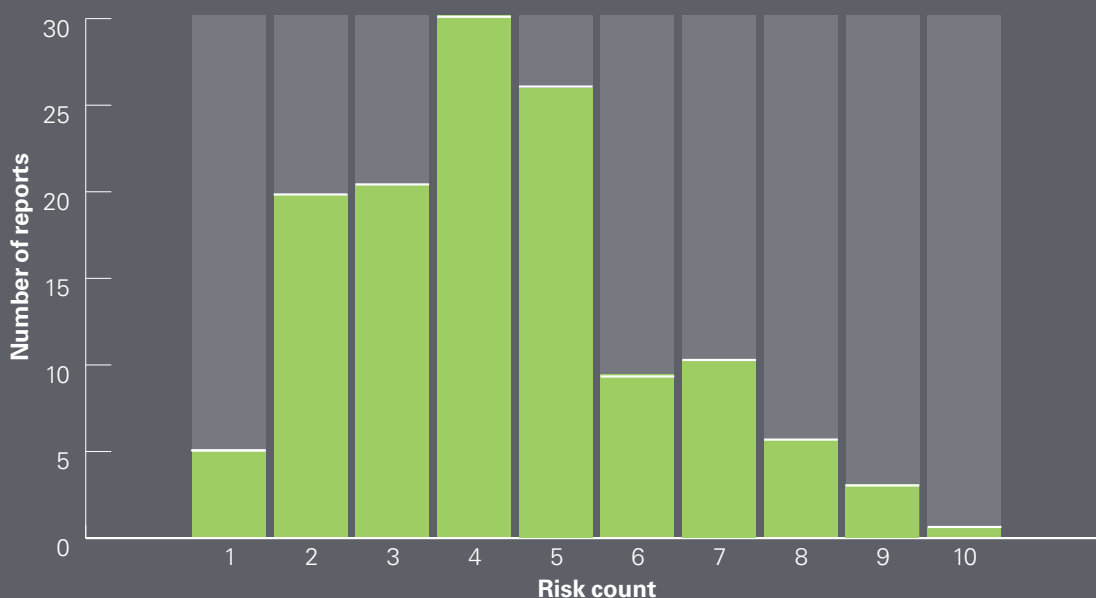
We looked at the number of issues reported, but, surprisingly, it wasn't straightforward in every case to identify what the committee regarded as the "significant issues ... in relation to the financial statements and how they were addressed."⁷ Whilst most committees clearly demarcated significant and lesser issues, a few appear to imply a distinction by dealing substantively with certain issues and then merely naming others, and a few deal substantively with

an issue outside of the section headed "significant issues" yet self-evidently the committee addressed it as significant. So there is an element of subjectivity in the statistics that follow. Nevertheless, we believe that the broad picture is representative.

As in our earlier survey, the number of issues discussed by audit committees shows a wide variation. Our expanded survey shows a wider range (from one to ten risks) than our earlier survey (two to seven risks). Yet the average number of

risks reported has barely changed (4.3 in this survey, 4.2 in our earlier survey). So has practice changed? We think not. This survey obviously represents a larger sample size and so includes a wider range of companies. We believe that our January survey represented a sample of the "middle ground." We are now seeing more examples outside of that range, but that middle ground has not moved.

How many issues are they covering?



⁷ UK Corporate Governance Code (2012), Provision C.3.8

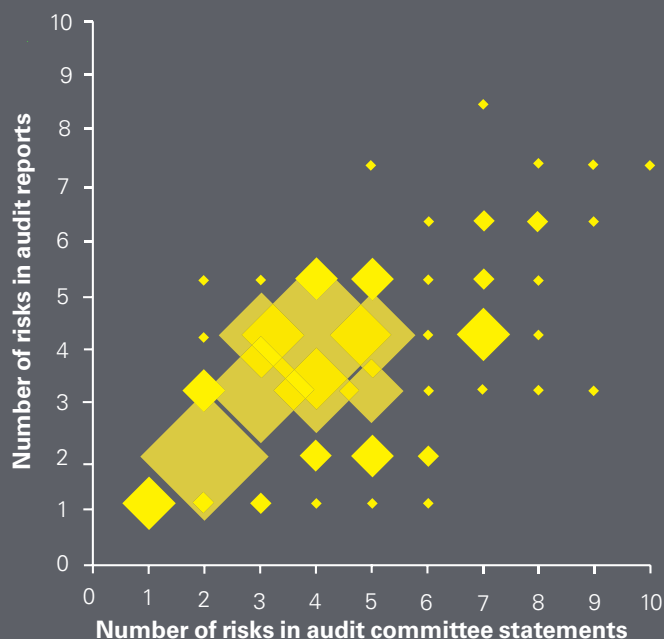
Comparing the number of issues with those in the audit report (and discounting the auditor's "deemed" risks), we found that sometimes there are more reported by the audit committee but sometimes fewer (and sometimes the same total number but different issues, though these are not apparent on our graph below). Where more are reported we found no common theme among the committees' additional risks. In our previous survey we speculated that, perhaps, audit committees felt that it would not lengthen their statement by much to include less significant issues too. We remain of this view.

Deemed risks:

Auditing standards deem two risks (the risk of fraud in revenue recognition and of management override of controls) always to be significant to the audit. Some audit reports include these risks but audit committees are not doing so as a matter of course. We discuss this further on page 19.

Perhaps more interesting is the question of why an audit committee would include fewer risks than the audit report (discounting the auditor's "deemed" risks). If the auditor includes a risk in the audit report, we would expect that the same issue would have been communicated by them to the audit committee. At the same time, the auditor is required to report to shareholders, by exception, if the audit committee's narrative "does not appropriately address matters communicated by the auditor to the audit committee"⁸. Since we have not seen any such reporting in our survey,

Risk count – compared with audit reports and excluding ISA 240 “boilerplate” risks



Each point in this chart represents a combination of a number of risks in an audit committee statement with a number of risks in the company's audit report. The size of the point represents the number of companies having that combination.

⁸ ISA 700 (UK and Ireland), paragraph 22B

[https://www.frc.org.uk/OurWork/Publications/Audit-and-Assurance-Team/ISA-700-\(UK-and-Ireland\)-700-\(Revised\)-File.pdf](https://www.frc.org.uk/OurWork/Publications/Audit-and-Assurance-Team/ISA-700-(UK-and-Ireland)-700-(Revised)-File.pdf)

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we looked at the additional audit report risks to follow up. In a number of cases we found that the risk related to internal controls, which the audit committees did address, albeit more generally and/or outside of its statement about the significant issues.

Returning to accounting issues, we found one audit committee that, in the spirit of transparency, explained why it did not consider a particular audit report item to be a significant risk. Another committee gave summary particulars of the additional matters reported to it by the auditor. Other committees named the other issues but made no substantive comment on them. There remain cases, however, where the committees appeared to make no reference at all to a risk reported upon by the auditor.

Perhaps more interesting is the question of why an audit committee would include fewer risks than the audit report



Audit reports - requiring more from the auditor

Alongside the changes for audit committees, auditing standards also now require more from the auditors in their reports. The principal changes require:

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

Different auditors are taking different approaches to this. Many auditors have settled on a "risk and response" style to describe the risks and audit work side-by-side. There is greater apparent variation in the approach to materiality.

Restructuring the report

These changes introduce much extra text into the report. Almost all auditors, including ourselves, 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.

In our reports, we begin with the opinion then follow with our explanation of the risks etc. We believe 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.

Much of the extra text introduced by these reforms is specific to the particular audit. We felt that we could make an audit report easier to read by replacing much of the long-standing, standardised,

generic text in our reports by a web-link, cross-referring to our website.

Another innovation is the introduction of tabular layout and, in just three reports, graphics. This can distil more complicated information into a more digestible form.

Audit report extract

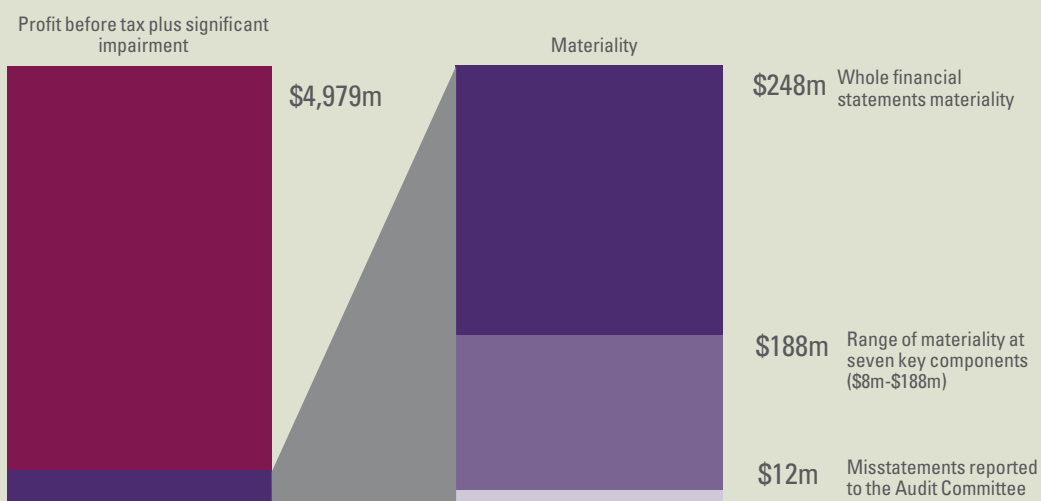
"As explained more fully in the Directors' Responsibilities Statement set out on page [x], the directors are responsible for the preparation of the Group financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2013a, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions."

(Closing paragraph from a KPMG LLP report)



Audit report extract

Materiality of the Group Financial Statements



(KPMG Audit Plc, report to the members of AstraZeneca PLC)

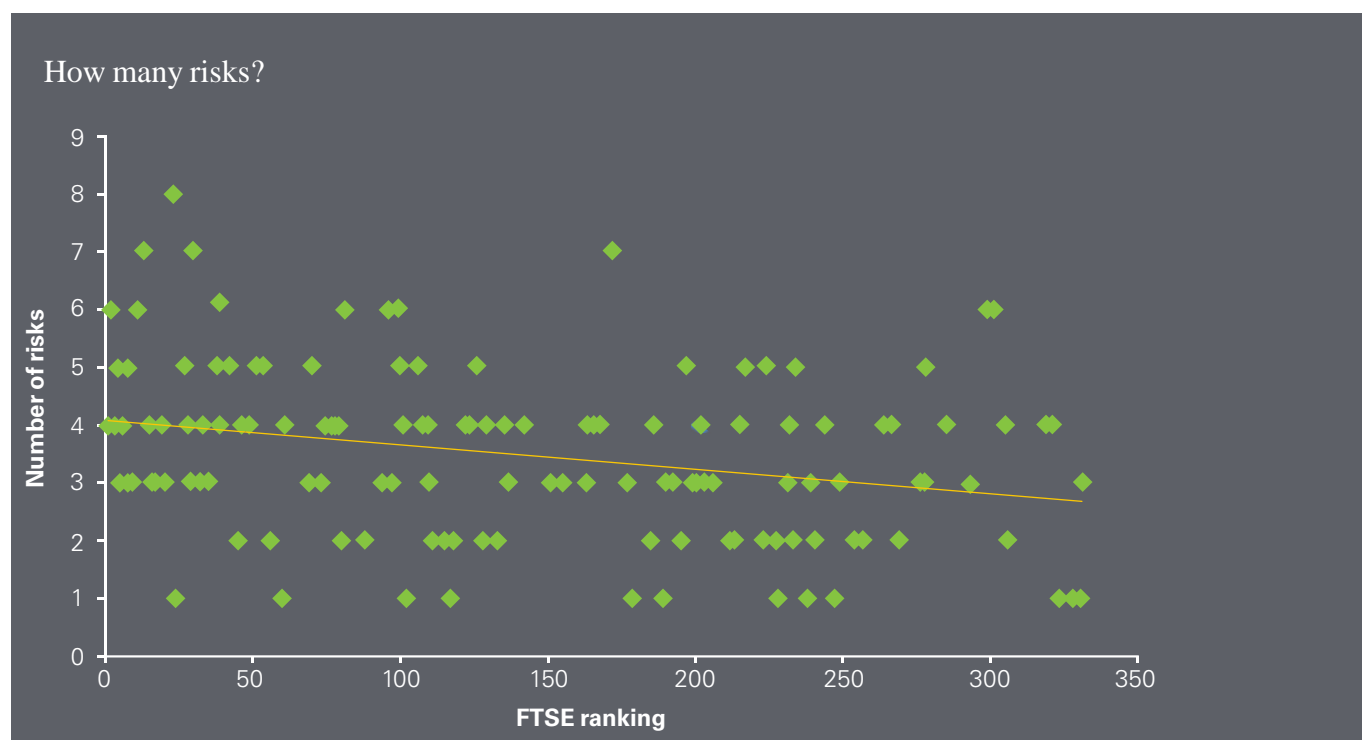
How many risks?

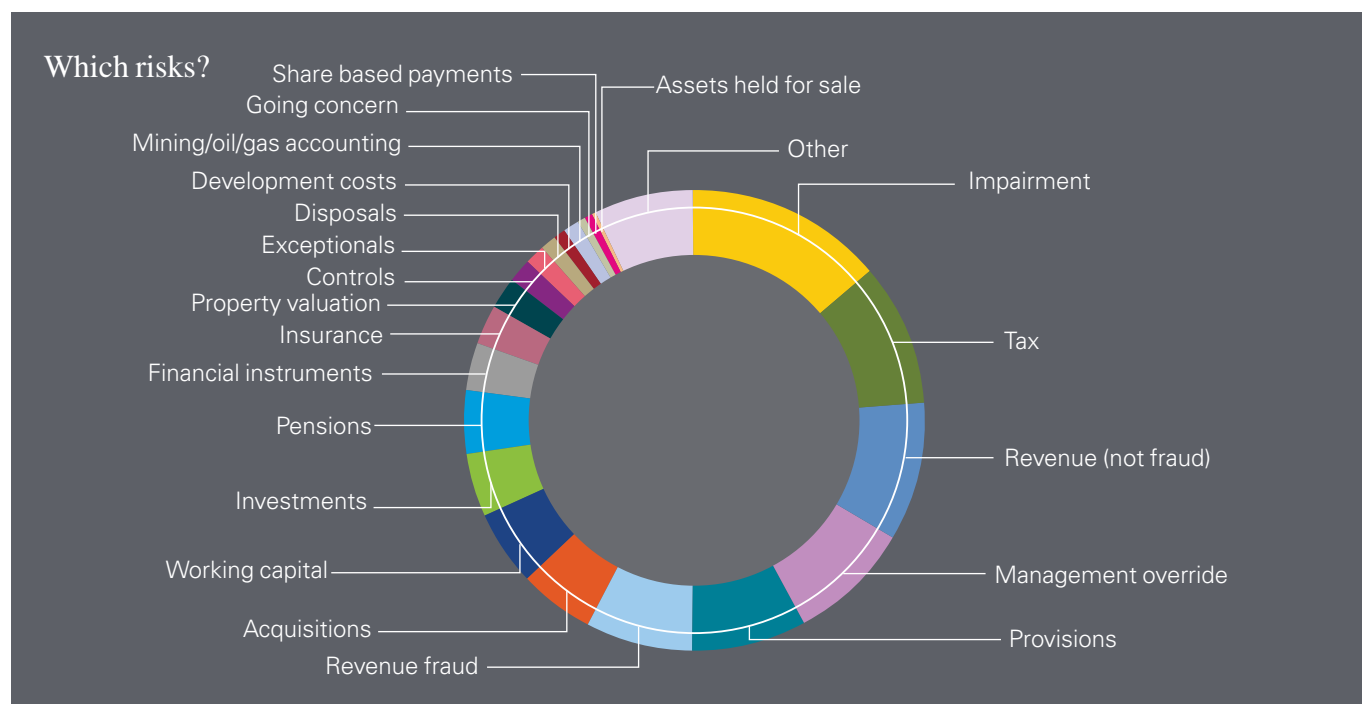
We looked at how many risks each audit report discussed. We decided to exclude two risks: management override of controls and fraud in revenue, where they were reported solely because auditing standards deem them always to be significant (and which we discuss further below).

We found that within an overall average of 3.5 risks, the average reduces as one moves through the FTSE table. This is not altogether surprising. Intuitively, larger companies are more likely to be more complex and/or diverse and so have a greater diversity of risks.

The more interesting point is the scatter of the risk count. It is widely scattered, and fairly consistently so across the whole FTSE 350, with the result that auditors of many FTSE 300+ companies are reporting just as many risks as the auditors of some FTSE 50 companies. We see this as a good sign; it confirms that auditor's reporting is responding to specific circumstances and hasn't been designed to conform to a pattern of smaller-company-fewer-risks.

It is perhaps more of a surprise that very low numbers of risks are quite common, even after discounting the investment and property companies (which one can easily understand as having only one or perhaps two significant audit risks in many cases). We found that in many of these cases the auditor also reported the generic risks deemed as significant by auditing standards (management override and revenue fraud – see below), effectively bulking up a report that otherwise would only report one or two risks.





What risks?

As we found in January, the most common risks remain impairment, taxation, provisions and revenue recognition – areas that can be subjective and that can apply across a wide range of types of business.

The largest single category, after impairment risks, is “other” (38 times). A significant proportion of these 38 occur only once. They often relate to accounting judgments, for example the appropriate accounting for aircraft maintenance arrangements, broadcasting royalties or particular powers over an investee. We believe that this reflects the breadth of issues considered by auditors. This outcome is consistent with our earlier survey, and again we see this as a positive; auditors are going beyond the “usual suspects” of impairment and revenue recognition and reporting the complete set of the real issues facing the company.

Deemed risks

Our survey has also found continued high incidence of reporting management override of controls and fraud in revenue, mainly by one accounting firm. However, whilst these risks are deemed always to be significant by ISA 240 it was not clear to us that they are always risks with the greatest effect on audit strategy or the efforts of the engagement team. We have seen only one report where there appeared to be specific cause for regarding it as an audit risk. In all other cases the description appeared to suggest they were included in solely due to the auditors’ reading of ISA 240⁹.

We previously said that we did not anticipate including “deemed” risks in our audit reports as a matter of course, and we have not done so. Others appear to endorse this approach. Research produced by Citi Research¹⁰, looking at 88 audit reports, said: “We do not think these standard disclosures ... are helpful

to investors, nor are they in our view consistent with the auditing standard guidance, that states that explanations (eg of risks) shall be ‘in a way that enables them to be related directly to the specific circumstances of the audited entity and are not, therefore, generic or abstract matters expressed in standardised language’. We also think they may confuse investors as to whether the risks disclosed are really the most important or simply included automatically.”

⁹ ISA (UK & Ireland) 240 The auditor’s responsibilities relating to fraud in an audit of financial statements
www.frc.org.uk/OurWork/Publications/APB/240-The-auditor-s-responsibility-to-consider-fraud.aspx

¹⁰ Citi Research (a division of Citigroup Global Markets Inc), citivelocity.com, “New UK auditor’s reports – a review of the new information,” March 2014

Describing the risk and audit work

As with our assessment of audit committee reports, we have scored the audit reports (on a scale of 0-5 – and see our criteria).

Our criteria:

We looked at whether:

- the description of the risks and responses was clear, understandable and specific rather than superficial and/ or couched in auditing jargon;
- the response addressed the risk;
- the response showed how external evidence was sought;
- the response covered any relevant accounts disclosures and whether such disclosures addressed the accounting judgment/ estimate.

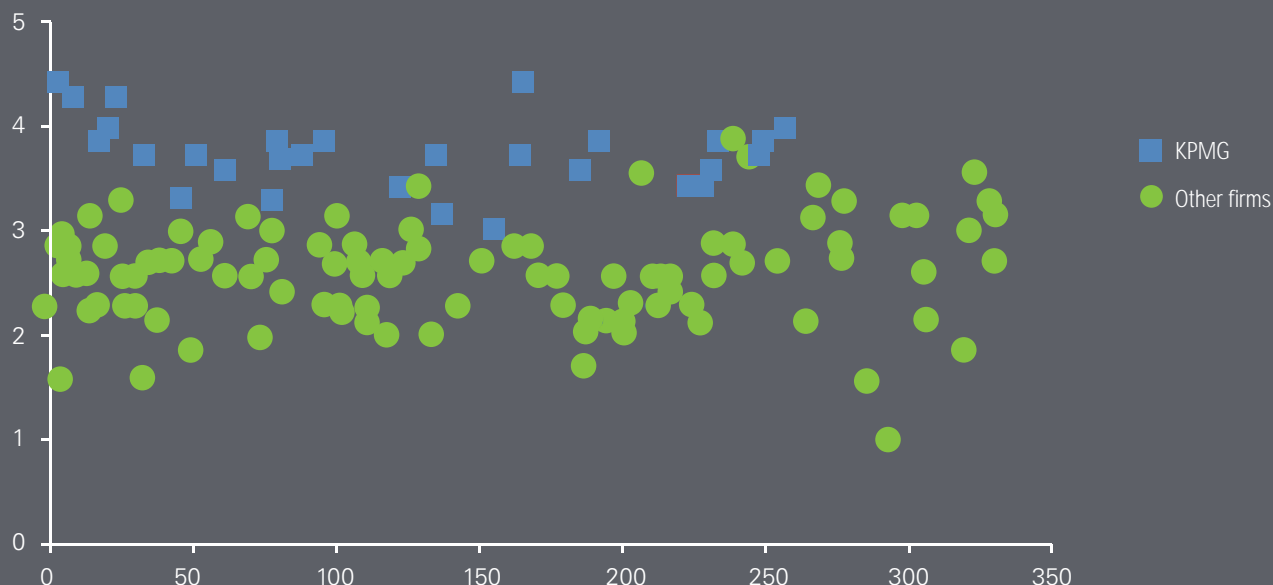
We concede that our scoring is rather subjective, and that, because the criteria are essentially the aims that we set ourselves when drafting our own reports, inevitably our own reports have scored well. Nevertheless, we believe that it does provide a rough and ready guide. For example, it shows a diverse range of scores across all positions in the FTSE 350 rather than being weighted up or down at one end. In particular the data appears consistent with the conclusions drawn by Citi Research based on their own analysis (see extract), including suggesting that our aims (and resulting criteria) are aligned with what investors value.

Broker's research note extract

"We also noted very significant variations in quality, with some reports adding little or no value with largely boilerplate comments, while others contribute significantly to investor understanding ...; in our view KPMG's contain the most useful analysis of risks."

(Citi Research, "New UK auditor's reports – a review of the new information", March 2014)

Rating audit reports



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A diverse range of scores across all positions in the FTSE 350

On pages 22 and 23 we have set out examples of descriptions of risks, illustrating the variation in approach. Some reports state that a matter is a risk, some state that the risk is caused by subjectivity, whereas our approach has been to try to explain the underlying circumstance and specifically why that leads to a risk for the accounts.

One of these extracts relates to going concern. A particular point worth noting is that none of the surveyed companies, for which going concern was an audit risk, had an emphasis-of-matter on going concern in their audit reports or stated in the accounts that the uncertainties were material ones casting significant doubt on going concern. So there is now more visibility of going concern audit work even when the final conclusion is that there is no material uncertainty. That may at first seem unusual, but it is what auditing standards now ask for: even though the audit work reached a satisfactory conclusion – whether that was on impairment, going concern or whatever – the auditor must disclose that it was a focus area of its work. It is a positive testament to companies and investors in the UK that the application of this to going concern has not attracted an adverse knee-jerk reaction.

The following pages also set out examples of different approaches to describing of audit work. In our reports we have aimed at going beyond naming the particular target of our audit work and beyond statements that we have tested or challenged it. We have aimed at describing the key audit work itself and at how we have brought our external perspective to bear and sought corroborating evidence from external sources.

One of the extracts deals with the auditing of contract accounting. Whilst many areas of accounting are inherently subjective, that is particularly so here. The accounting in large part depends on assessment of the extent and cost of future works and each contract is largely unique, such that external benchmarking is difficult. Much of the audit work is about gathering information from as many different sources as possible within the company itself, observing contract performance as closely as possible, looking at the company's track record of forecasting contract outcomes and then forming one's own view. Accordingly, explaining what the auditor has done and why that is sufficient is one of the most challenging areas of these new long-form audit reports.



Audit report extracts: impairment risk

"We focused on the directors' assessment of the carrying value and annual impairment reviews of goodwill (...) long lived intangible assets (...) and property, plant & equipment (...) because they involve complex and subjective judgements by the directors about the future performance of the business. (Refer to note 6 to the financial statements.)"

(Report on a natural resources company)

"The PGM industry has experienced rising costs, and subdued demand resulting in a depressed pricing environment. Other producers in the industry have closed unprofitable shafts, and have recognised impairments against assets. The Company's market capitalisation remains below the share of net assets attributable to shareholders of the Company. The Akanani asset was impaired in 2012, and any change in assumptions could lead to further impairment, or reversal of impairment. As such there is a risk that the group's

assets need to be impaired, or in the case of Akanani, impairment may need to be reversed. As described in the Report from the Audit & Risk Committee on page 60, consideration of impairment is one of the key judgemental areas that our audit is concentrated on."

(KPMG Audit Plc, report to Lonmin Plc shareholders)

Audit report extracts: going concern risk

"We consider that the following areas present the greatest risk of material misstatement in the financial statements: ... the continued use of the going concern assumption."

(Report on a leisure company)

"The Group's liquidity and solvency position is stressed as described in

section 2 of this report above. Assessing whether the going concern basis of accounting is appropriate requires significant judgement and the application of a break-up basis could have a significant effect on the amounts included in the financial statements. Given the current position of the Group, it is of particular importance that the disclosure in the financial statements of the Directors' judgements in this regard

and of the nature of any material uncertainty which may cast significant doubt as to the Group's and the Company's ability to continue as a going concern is clear and comprehensive."

(KPMG Audit Plc, report to NewWorld Resources Plc¹¹ shareholders)

¹¹ This company is not within the FTSE 350. We have included this extract as we believe it represents an example of what can be achieved in providing detailed risk information to shareholders

Audit report extracts: response to tax risk

"We have tested the validity of the amounts claimed from the ... government, including those currently in dispute. We challenged management's assumptions relating to the recoverability, classification and measurement of the balance. We agreed

the related disclosure provided in the Annual Report and Accounts."

(Report on a natural resources company)

"In this area our principal audit procedures included: assessment of correspondence with the relevant tax authorities, and the use of our own local and international tax specialists to analyse and challenge the assumptions

used to determine tax provisions based on our knowledge and experiences of the application of the relevant legislation by authorities and courts.

We also assessed the adequacy of the Group's disclosures in respect of tax and uncertain tax positions."

(KPMG Audit Plc, report to AstraZeneca PLC shareholders)

Audit report extracts: response to contract accounting risk

"Our work on the recognition of contract revenue, margin and related receivables and liabilities included: tests of controls over the recognition of contract revenue and margin; challenge of management's key judgements inherent in the forecast costs to complete that drive the accounting under the percentage of completion method, including a review of the contract terms and conditions, management's assessments of the forecasts, the existence and valuation of claims and variations both within contract revenue and contract costs; and an assessment of the recoverability of related receivables."

(Report on a construction company)

"The directors have detailed procedures and processes, called Lifecycle Management (LCM), in place to manage the commercial, technical and financial

aspects of the Group's long-term contracts. The LCM process includes the regular preparation of a Contract Status Report (CSR) which includes key accounting information for the relevant contract. We considered the design and tested the effective operation of key LCM controls. For significant contracts, determined on the basis of technical and commercial complexity and profitability of the contract, we also: obtained an understanding of the status of the contract through discussions with contract project teams and directors at a Group and operating business unit level, attendance at project teams' contract review meetings, and examining externally available evidence, such as customer correspondence; and challenged the key estimates and assumptions applied in determining financial status of these contracts by: corroborating the consistency of changes in the updated contract financial information summarised in the year-end

CSRs to other financial information received; considering how key uncertainties are reflected in the contracts' status taking into account externally available information; assessing whether allowances for risks and uncertainties are consistent with past experience considering the maturity of the contracts and the extent of technical or commercial risk identified; and using our cumulative knowledge of contract issues to assess the appropriateness of the contract positions reflected in the financial statements at the year end. We performed the above procedures, amongst others, in respect of the Group's significant contracts which included, but are not limited to: Saudi Typhoon aircraft; Radford Army Ammunition Plant; and Queen Elizabeth Class aircraft carriers."

(KPMG Audit Plc, report to BAE Systems plc shareholders)

What the auditors found

As it stands, a new audit report tells shareholders the key risks and the auditor's response to them – what the auditor did to address them. However, it does not tell shareholders what the auditor found as a result of that work. It does not say, for example, how acceptable the policies, estimates or disclosures were. Why not though?

With the agreement of three of our clients – and we are very grateful to them for their commitment to shaping the future – the audit reports to those companies' shareholders do just that. So whilst our KPMG reports normally set out under

each audit issue, "the risk" and "our response", on these occasions we added, "our findings" (one extract is set out here). One of these reports was described in Citi Research's Review as, "the best we have seen to date", and the inclusion of findings as, "very useful".

We did this to promote debate. So on the Restoring Trust section of our website¹² we have uploaded some materials explaining the idea, giving extracts from the reports and pointing to some of the pros and cons. Our view is that we'd be ready to deliver this, if that's the consensus; but the consensus isn't for auditors to decide. The way forward is whatever the investment community

and companies can agree on, implemented in auditing standards.

It may be, however, that this will be overtaken by a new EC law. The EC Audit Reform Regulation, currently awaiting final ratification from the Council of Ministers and then official publication, will require auditors to report their key observations where relevant (see extract). On the face of it, this requires findings to be reported, albeit we expect that auditing standards will address the question of where this is relevant. The law is expected to enter into force during the second half of 2014 and become applicable in 2016.

Audit report extract

"Our findings: Our testing identified weaknesses in the design and operation of controls. In response to this we assessed the effectiveness of the Group's plans for addressing these weaknesses and we increased the scope and depth of our detailed testing and analysis from that originally planned. We found no significant errors in calculation. Overall, our assessment is that the assumptions and resulting estimates (including appropriate contingencies) resulted in mildly cautious profit recognition."

(KPMG Audit Plc, report to Rolls-Royce Holdings plc shareholders)

Forthcoming EC law

"The audit report ... shall at least ... (c) provide in support of the audit opinion, the following:

- (i) *a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement from fraud;*
- (ii) *a summary of the auditor's response to those risks; and*
- (iii) *where relevant, key observations arising with respect to those risks."*

(Article 10(2), Audit Reform Regulation¹³)

KPMG LLP (UK) Audit

Audit reports – field testing a bold idea

Restoring Trust

Shaping the future of corporate reporting

When I launched KPMG's Restoring Trust initiative last year I said that it was time for change. Since then we've seen immense change in audit reporting: the new "long form" audit report. I really do think it is a positive change, one that should help the dialogue between companies and shareholders. We haven't yet seen a complete season of these new reports, but, as I said in January when we published our survey of early reports, there are some great examples of what can be achieved. In a very short time we have come a very long way from the traditional binary audit opinion.

But what next?

The challenge is this: as it stands, a new audit report tells shareholders the key risks and the auditor's response to them – what the auditor did to address them. In other words, what risks did the auditor check under and how did he go about testing them over? However, it is not telling shareholders what the auditor found when he looked under those risks. It does not say, for example, how probable the various outcomes or disclosures were.

So we asked ourselves a simple question: Why not?

If we truly want audit to make a difference, not only do we have to ask those challenging questions, but offer bold answers – being as frank as possible. So we have put it to the test by issuing a small number of audit reports that extend the new audit report, beyond the minimum required, to offer something that we found. With the agreement of our clients, Rolls-Royce Holdings plc and New World Resources Plc – and we are very grateful to them for their commitment to shaping the future – the audit reports to their shareholders do just that: they include details of what we found. So whilst our KPMG reports normally set out under each audit issue, "the risk" and "our response", on these occasions we have added "our findings".

Our findings: We found that the Group has developed a framework for selecting the accounting basis to be used which is consistent with accounting standards and has applied this consistently. For almost all the agreements entered into during this year, it was clear which accounting basis should apply. Where there was room for interpretation, we found the Group's judgement to have been balanced.

Support to Rolls-Royce Holdings plc shareholders

Audit Reports | March 2014

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¹² <http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/Auditreportsthatmakeadifference.aspx>

¹³ Final draft of a regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC

Related accounts disclosures

Many of the matters included in audit committees' and auditors' reports are subjective accounting matters, whether subjective decisions as to accounting methods or subjective estimates. So as part of our survey we looked at the accounts' disclosures of significant judgments and estimates (required by IAS 1).

First of all, we found that many audit reports (including our own) specifically say that the auditor considered the adequacy of relevant disclosures. Second, we found some good examples of disclosure of judgments and estimates (see extracts), corresponding to audit report risks, and being not only detailed as to the nature of the

subjective factors but also quantified as to sensitivity.

However, this quality of disclosure was not universally available. In fact around half of all cases saw some shortfall in matters disclosed by the accounts compared with the audit report. The quality of IAS 1 disclosures has long been criticised by the FRC (for example, in their 2012¹⁴ and 2011¹⁵ annual reviews). It seems likely that the FRC hoped that risk disclosures by the auditor and audit committee would, as a by-product, drive up the quality of the accounts' disclosures; but, whilst we think that there has been an improvement, it appears that there is still more that could be done.

Accounts extracts

"The total net accrual included in the Group Financial Statements to cover the worldwide exposure to transfer pricing audits is \$523m, an increase of \$100m compared to 2012. AstraZeneca faces a number of transfer pricing audits in jurisdictions around the world and, in some cases, is in dispute with the tax authorities. The issues under discussion are often complex and can require many years to resolve. Accruals for tax contingencies require management to make estimates and judgements with respect to the ultimate outcome of a tax audit, and actual results could vary from these estimates. The international tax environment presents increasingly challenging dynamics for the resolution of transfer pricing disputes ... Management continues to believe that AstraZeneca's positions on all its transfer pricing audits and disputes are robust and that AstraZeneca is appropriately provided. For transfer pricing audits where AstraZeneca and the tax authorities are in dispute, AstraZeneca estimates the potential for reasonably possible additional losses above and beyond the amount provided to be up to \$529m (2012: \$522m; 2011: \$375m), however, management believes that it is unlikely that these additional losses will arise. It is possible that some of these contingencies may reduce in the future to the extent that any tax authority challenge is unsuccessful, or matters lapse following expiry of the relevant statutes of limitation resulting in a reduction in the tax charge in future periods."

(AstraZeneca PLC)

"The hotel loyalty programme, IHG Rewards Club, enables members to earn points, funded through hotel assessments, during each qualifying stay at an IHG branded hotel and redeem points at a later date for free accommodation or other benefits. The future redemption liability is calculated by multiplying the number of points expected to be redeemed by the redemption cost per point. On an annual basis the Group engages an external actuary who uses statistical formulas to assist in the estimate of the number of points that will never be redeemed ('breakage'). Actuarial gains and losses on the future redemption liability are borne by the System Fund and any resulting changes in the liability would correspondingly adjust the amount of short-term timing surpluses and deficits held in the Group statement of financial position. The future redemption liability, which is included in trade and other payables, was \$649m at 31 December 2013. Based on the conditions existing at the balance sheet date, a 5% decrease in the breakage estimate would increase this liability by approximately \$31m."

(InterContinental Hotels Group PLC)

¹⁴ FRRP's Annual Report 2012:

<https://www.frc.org.uk/Our-Work/Publications/FRRP/Financial-Reporting-Review-Panel-Annual-Report-201.pdf>

¹⁵ FRRP's Annual Report 2011 <https://www.frc.org.uk/Our-Work/Publications/FRRP/Annual-Report-2011.pdf>

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Materiality

A wealth of information about audit materiality is now entering the public domain for the first time. This is a further step forward in the transparency of audit.

We think that this information is likely to spark some interest both inside and outside of the auditing profession.

For those outside, it is not only that the monetary amounts may appear large, but we have also seen broker's reports querying why those companies reporting more risks, and so perceived as apparently higher risk, do not also have a correspondingly lower level of materiality.

It is good that such questions are being asked – that investors are interested in audit – though the answer is that risk and

materiality are *both* drivers of the audit work. The volume of work is determined by a combination of the assessment of risk and the materiality. Increasing the risk assessment increases the work done at any given level of materiality.

Whole-financial statements materiality itself (see our summary of its derivation) is not a level of error "tolerance" – errors under this value are not ignored and the final judgement on cumulative errors is, in any case, qualitative ie regardless of size. The auditor must get enough audit evidence such that the risk of cumulative undetected errors in excess of the materiality figure is acceptably low. This is a judgement area for the auditor and not simply a matter of a mechanical calculation.

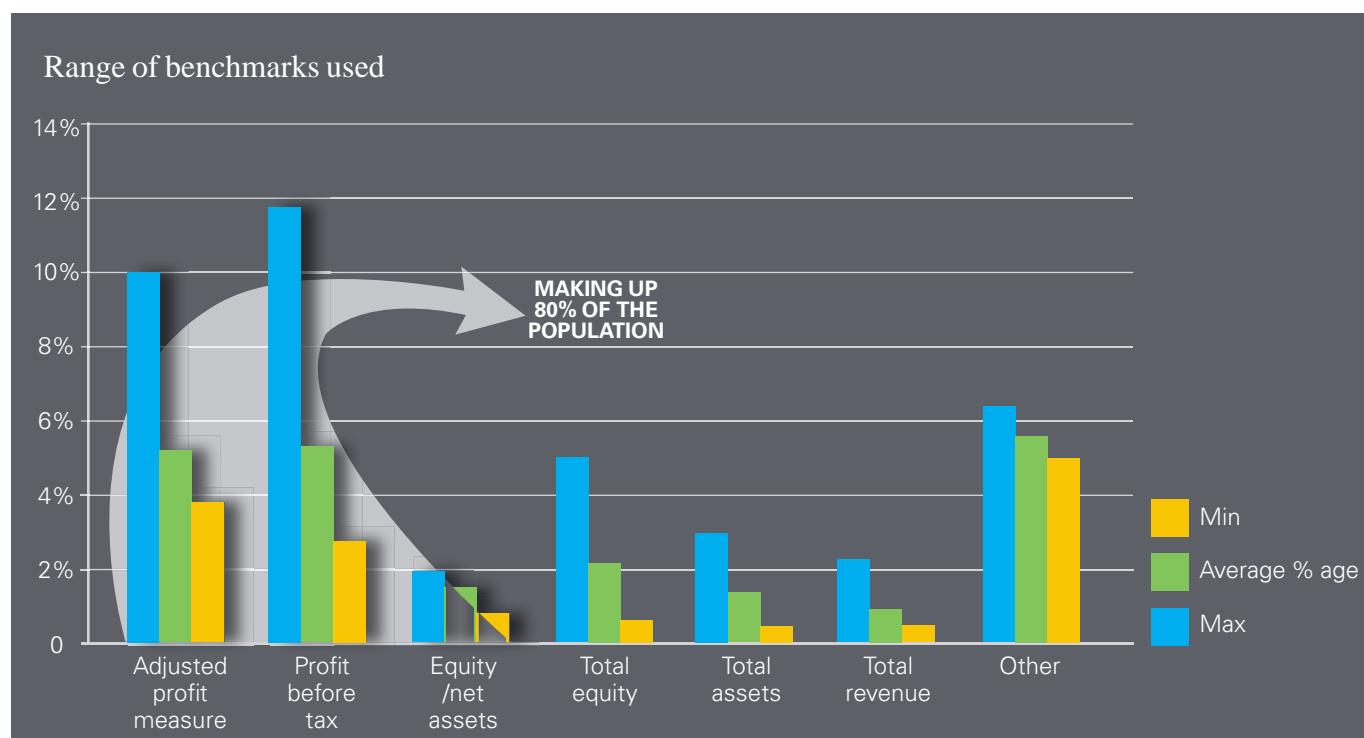
Materiality under auditing standards

Under auditing standards there are three elements to setting materiality:

The benchmark – the number that shareholders look to in assessing financial performance.

Determine the materiality figure, based on the auditor's knowledge of the company and its risks.

Compare the materiality figure to the benchmark figure – a "sense check" to ensure the materiality figure is within an acceptable range.



“““

This information is likely to spark some interest both inside and outside of the auditing profession

In designing a group audit so that there is an acceptably low risk that the total undetected errors could not exceed the whole-financial statements materiality figure, auditors have to apply materiality levels to individual audits of components of the group. In most cases, the reports also give the range of these component materialities. For example, we do so in our reports; we believe that this may help to give a better understanding of the group audit.

Our survey also found that in all cases auditors disclose the threshold for reporting audit differences to audit committees.

When we look at the choices of benchmark, profit measures continue to dominate. This is in part due to the makeup of the FTSE 350: equity or asset measures are more commonly used by companies where asset measures are key, such as investment trusts or property companies, who are in the minority. The majority of companies use a profit measure as their primary benchmark. We found a small number of “other” benchmarks used, but no recurring themes.

The range of percentages is slightly wider than seen in our earlier survey. Our data shows a clustering, although with some apparent outliers (including some of our own reports) of materiality at around 5% of profit before tax. So we expect that the auditors themselves, us included, will study these data carefully and consider how they might respond both generally and on individual audits.

The ranges may need to be read with a small element of caution. Not only is the setting of materiality a complex matter, but, for example, auditors may not need to rebase materiality downward for the effect of their own audit adjustments against profit; so the more audit adjustments are made, the higher the percentage may appear (though it would also be unwise to assume that this explains any individual above-average figure). Further, there is a high incidence of adjusted profit benchmarks, and, of course, the adjustments are not necessarily consistent.

In our earlier survey we commented on the FRC’s reminder¹⁶ that whilst an adjusted profit measure can be an acceptable benchmark, those adjustments should not be recurring items, such as amortisation of intangibles. At that time we said the FRC’s comments may lead to changes in the way benchmarks are determined, but we have not yet seen significant changes in the use of these benchmarks.

If in the months to come the publication of these data encourage investors to engage with auditors and companies, we should welcome such healthy dialogue. After all, materiality is about shareholders’ reactions to accounts, and they would ultimately meet the increased audit cost of lower materiality (through lower profits for shareholders). So if this crystallises a debate about materiality, we trust that the FRC would step forward to provide a forum where interested parties can reach a consensus.

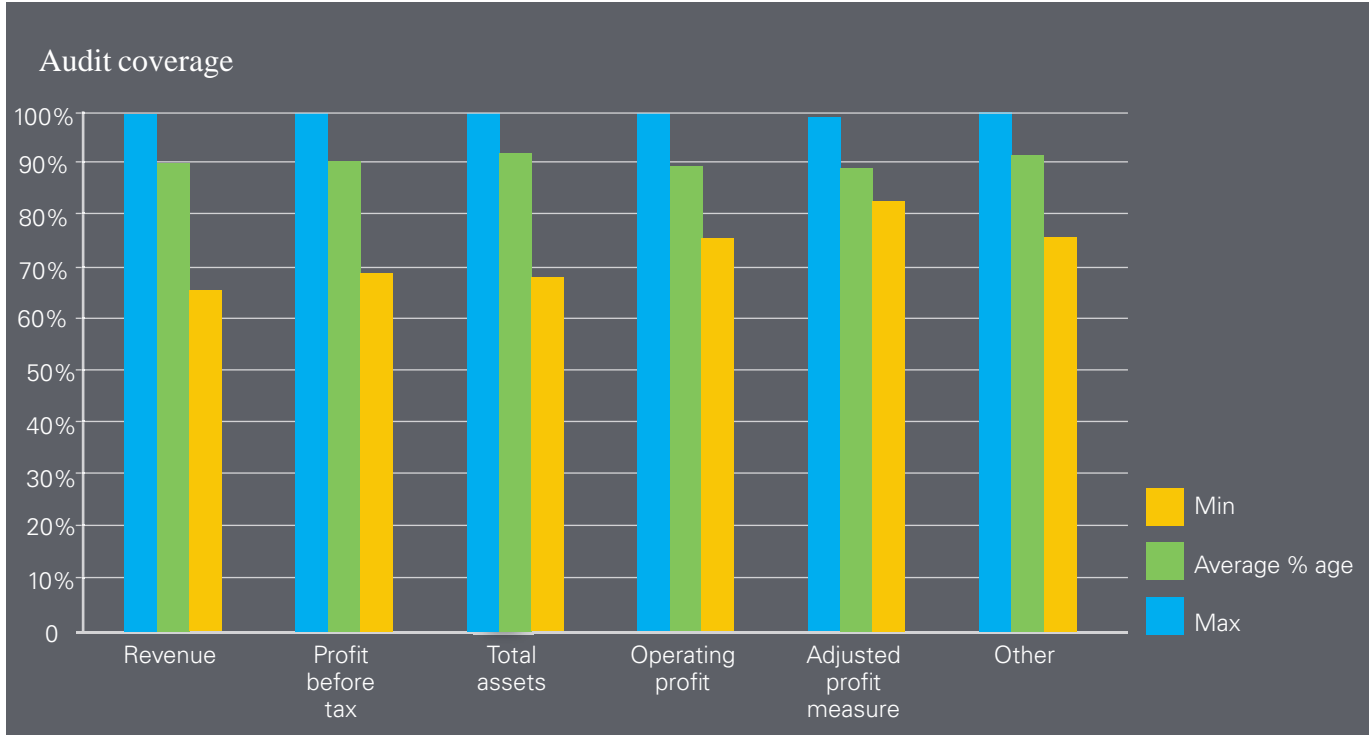
¹⁶ Audit Quality Thematic Review: Materiality

www.frc.org.uk/Our-Work/Publications/Audit-Quality-Review/Audit-Quality-Thematic-Review-Materiality.pdf

Audit coverage

The auditing standard requires the auditor to provide an overview of the scope of the audit. All but one firm consistently provide information on the proportion of the group that has been subject to full scope audit or some other form of audit procedures. This is quantified against key financial statement line items, such as revenue or profit before tax. However, in general no distinction is drawn between the full scope and other more limited audit procedures – only a single percentage is given.

Whilst the range of coverage percentages may seem surprising at first, it is worth noting that audit is risk-based. So if the main risks are concentrated in only certain components of the group, then a lower full scope percentage may arise as the audit effort is focussed on those. One example of this is where there is a large number of individually insignificant components (see extract). Another example is a group’s shared service centre, which concentrates on a few transaction types and is therefore subjected to audit procedures relevant to them, and hence counting in the coverage statistics only as limited scope procedures.





Audit report extract

"The Group is characterised by a diverse geographic footprint, represented by a large number of medium and small sized operations. These Group reporting procedures covered 70% of total Group revenue; 70% of Group profit before tax; and 73% of Group total assets. The remaining 30% of Group revenue, 30% of Group profit before tax and 27% of Group total assets is represented by 284 reporting units, none of which represented more than 1.2% of total Group Revenue, 1.7% of Group profit before tax, or 1.0% of Group total assets individually. We consider the aggregate risk when performing our audit planning and during our final analytical procedures over the Group financial statements."

(KPMG Audit Plc, report to Intertek Group plc shareholders)

Some examples explain how the auditor broke the group down into components. We feel that this text could be useful to a reader of the annual report, but may appear to be semi-standard when compared with other companies, reducing its value.

We also field tested, in two examples, a slightly different model: additional explanatory narrative setting out how we

made our risk assessment and how it affected the scope of the audit and determined our key audit risks. We should welcome investors' feedback on the usefulness of this approach, which, admittedly, does add significantly to the length of the report.

Audit report extract

"The starting point for our audit was a consideration of the inherent risks to the Group's business model and how these have been mitigated. This included understanding the strength of the Group's capital and liquidity position, the diversification of its assets, the flexibility and tenor of its balance sheet and the management of its cost base. We assessed and challenged the inherent risks with reference to independent economic forecasts and commentary, the perspectives of our in-country audit teams on their local economies and banking industries, the views of our specialists in a number of areas including bank regulation, IT, tax and financial crime prevention, the views of the Prudential Regulatory Authority, the significant changes taking place in banking regulation, both in the UK and in the other jurisdictions in which the Group operates, [and] checking for consistency between (among others) the Group's budgets, regular forecasts, stress testing, reporting to the Audit,

Board Risk and Group Risk Committees and the many discussions we have with senior management in different countries.

We also considered the Group's control environment and in particular whether its systems were processing transactions completely and faithfully, and included appropriate controls designed to prevent fraud. Our work included testing the key controls over the processing of transactions and the key inter-system, bank and custodial reconciliations as well as trade confirmations. In addition we sought to apply industry lessons learned from recent dealing room issues at other banks in our testing of controls.

These assessments enabled us to form a judgment on going concern and also highlighted the key areas of financial statement risk on which our audit has focused. By looking at both broad risk themes across the Group and particular concerns in specific geographies and businesses, we were able to calibrate our work to financial statement risk

more precisely. In particular we identified the following issues: economic difficulties in India caused some stress in the Group's wholesale portfolio; high consumer debt levels plus an economic slowdown in South Korea caused some stress in the Group's consumer portfolio; more generally these factors in South Korea continued to depress profitability there; and, while the UAE economy is recovering and property prices are rising, risk in the portfolio does remain from the debt overhang that arose in the financial crisis.

Having addressed the going concern assumption and whether the Group's database of transactions was a sufficient underlying basis for the accounts, the risks of material misstatement lay in decisions over loan and goodwill impairments and the valuation of financial instruments."

(KPMG Audit Plc, report to Standard Chartered PLC shareholders)



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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

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