

## Audit reports – field testing a bold idea



# Restoring Trust

## Shaping the future of corporate reporting



**Tony Cates**

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 rocks did the auditor check under and how did he go about turning them over? However, it is not telling shareholders what the auditor found when he looked under those rocks. It does not say, for example, how acceptable the policies, estimates 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 these challenging questions, but offer bold answers – daring to think differently. 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, by also setting out what 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 that do just that (some extracts are set out here). 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. ”**

*(report to Rolls-Royce Holdings plc shareholders)*



#### **So what did we learn from the experience?**

Well, unsurprisingly, distilling all the professional judgment that go into an audit into a few words was not always straightforward. In particular, a binary finding – eg, that an estimate is acceptable – would be of little value; after all, that the estimates are acceptable is inherent in an overall clean opinion. Instead what is required is graduated findings that say something about whereabouts in a range matters sit. And explaining an accounting estimate was simpler than the relative merits of an accounting treatment.

Our experience would, I trust, provide valuable insight for the Financial Reporting Council (FRC) if they choose to require this approach across the profession. We'd need to be careful, however, that any auditing standard would not "standardise" the report – which would be a step back to the old days of boiler-plate – but provide a framework to enable comparison between companies. However, I should not seek absolute "grading" consistency, which would be difficult to achieve: there is greater value in the application of professional judgement than in the result of a mechanical process.

However, we didn't put this innovation to the test primarily for the "practical tips". Rather, I want this innovative audit report to kick-start debate: by showing investors, audit committees, companies, and the audit profession as a whole, what could be achieved.

**“ 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. ”**

*(report to Rolls-Royce Holdings plc shareholders)*



### **So is there a consensus among stakeholders as to whether this is a step forward?**

That has to start with a mandate from the investor community, as audit reports are for shareholders. So I'd ask investors, would you value this?

However, we must remember that audit facilitates the stewardship relationship between shareholders and the company. So it's also important to know what companies think, both executive directors and audit committees. In fact, audit committees perhaps have a unique perspective in this debate. They see the investor's perspective and the insider's. So I'd also ask boards, first, whether you see would see this as a demonstration of your commitment to good governance that warrants stepping outside the comfort zone? Second, are you content that it would not be a step towards replacing boards' judgments with those of their auditor – eg, in order not to be seen as deviating from what the auditor considers is the middle-of-the road position on subjective accounting matters? I should not want boards to see this as the audit tail wagging the company dog.

When I launched Restoring Trust I said we would innovate. Whether you agreed or disagreed we wanted to hear your views, and our [Restoring Trust website](#) is a platform for just that.

We've now put a bold suggestion to the test. So whether you are an investor, executive or audit committee member, please do visit our site. We want to shape the future of corporate reporting, including audit, but we won't do that alone. Is this the future of audit reports? If a favourable consensus can be forged among investors and companies, no doubt with the FRC's help, then at KPMG we'll be ready to deliver it.

**“ Our findings: We found that the third party expert was objective and had the appropriate experience and expertise to estimate the Group's closure and restoration provisions. We found the assumptions and resulting estimates to be acceptable but mildly optimistic resulting in a somewhat lower liability being recorded than might otherwise have been the case and that the Group's disclosures appropriately describes the significant degree of inherent imprecision in the estimates. We found no errors in calculations. ”**

*(report to New World Resources Plc shareholders)*

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