The audit report journey

Audit reporting is moving rapidly – how far and how fast are important issues that need debate.

Audit Committee Institute part of
KPMG Board Leadership Centre

Foreword

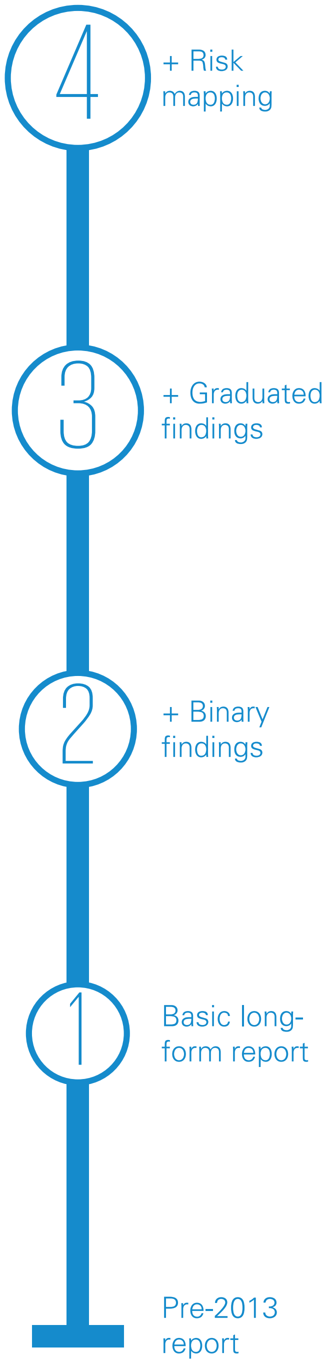
Audit reporting began a remarkable journey in 2013. That year the long-form report was introduced. Suddenly shareholders were provided with insight about how the auditor had arrived at his opinion and auditors were communicating with their ultimate client – the company's shareholders.

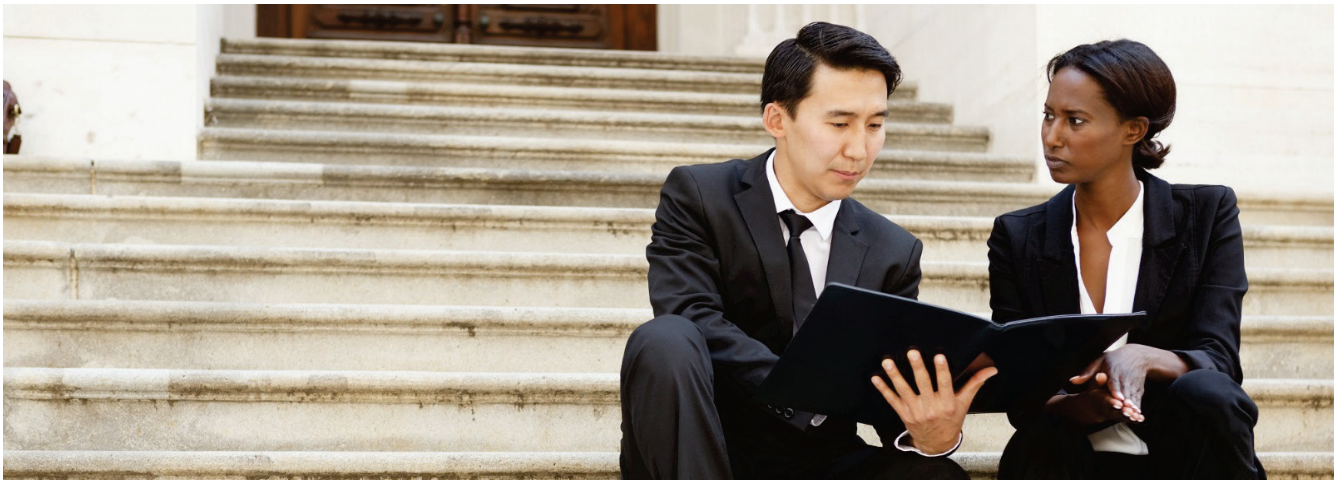
Innovation took off. KPMG field-tested reports with 'graduated findings' – how cautious or optimistic estimates were. For 2014 'graduated findings' was rolled out as an open offer to companies, and other firms introduced binary findings. In 2015 KPMG have gone a step further and included audit planning "risk maps" in some reports to better articulate the wider picture of audit risks.

This journey prompts two questions. First, for any individual company, which step or stop along this journey, which we explain here, do you want to reach? There is no requirement to go beyond the FRC standards, but audit committees might want to actively consider - and talk to shareholders - about where they should be. Of course, not everyone wants or needs to be in the vanguard of change, and we respect companies' views.

The second question is this: in the near future, for public interest companies, what step will regulation require audit reporting to reach? EU audit reform, taking effect later this year, may require more than the basic long-form report. So there needs to be a debate and consensus about whether and how much further it goes. Two groups have a strong interest in this: the investment community and corporates.

In this paper we look at each step along the journey and the need to settle the question of how far up the line the UK's implementation of the EU rules move reporting.





1 The basic long-form report – now for AIM companies too

This level of report is currently required for all premium listed companies and any that voluntarily comply with the UK Corporate Governance Code. So it has not been required, for example, for AIM companies. This is set to change. New auditing standards will require it, for years commencing on or after 17 June 2016, for companies on AIM or any other market.

The rationale is to stay in line with new international rules. Equally, however, annual reporting to outside shareholders – stewardship – is not significantly less important for an AIM company than for a fully listed company. Perhaps it is more important, since AIM shareholders may not be able to engage individually and regularly with their companies in the way that they do for fully listed companies.

That stewardship relationship depends on trust, and the audit report – which is for, and addressed to, shareholders –contributes to that by providing assurance over the annual accounts. The long-form report takes matters a stage further by moving beyond a binary assurance opinion and standardised text. It provides shareholders with a window into the audit – an understanding of how that binary opinion was formed and hence more confidence in the audit. It sets out the materiality measure used, the degree to which parts of the group were scoped-in to the audit and, most importantly, specifically what audit issues the auditor faced, their underlying causes and how they were addressed. It tells a company's shareholders what their auditor did on their behalf, explained in terms highly specific to the audit in question.

“ Goodwill

The risk There is a risk of irrecoverability of the Group's goodwill balance due to varying levels of demand in certain markets. An impairment assessment of goodwill is carried out annually by the Group by assessing the value in use of Group's of cash generating units (CGUs) which requires significant assumptions about future developments. Due to the inherent uncertainty involved in forecasting and discounting future cash flows, which are the basis of the assessment of recoverability, this is one of the key judgemental areas that our audit concentrated on.

Our response In this area our audit procedures included testing the Group's budgeting procedures and the principles and integrity of the Group's discounted cash flow model. This included comparison of the key assumptions to external data as well as our own assessments in relation to key inputs such as revenue growth, gross margin assumptions, cost inflation and long term growth rates based on our knowledge of the industry. We considered the historical accuracy of the Group's growth assumptions and used external data and our own valuation specialists when assessing the discount rate applied. We compared the Group's market capitalisation to the valuation derived from the forecasts used in the impairment calculations to assess their reasonableness. We further critically assessed the sensitivities applied by the Group. We also assessed whether the Group's disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions reflects the risks inherent in the valuation of goodwill.

KPMG LLP, report to the members of James Fisher and Sons plc ”

Other example reports for reference

Merlin Entertainments plc

Standard Chartered PLC

Charles Stanley Group PLC

Co-operative Group Limited

2 Binary findings

Whilst KPMG pioneered the reporting of graduated findings (see page 4) in their 2013 report to the members of Rolls-Royce Holdings plc it is a huge step up, and one that many companies, notwithstanding a strong commitment to good governance, feel naturally hesitant about taking. A smaller, or perhaps intermediate, step is binary findings.

In contrast with a graduated finding that indicates the auditor's assessment of, say, the degree of caution or optimism within the acceptable range for a key accounting estimate that the audit focused on, a binary finding reports whether it was within or outside the acceptable range. Naturally, this provides less insight into the process by which the auditor formed his opinion. After all, in most cases one might expect that all of the key risk areas would be within the acceptable range if the audit opinion is unqualified. However, that is not necessarily always so. For example, this approach would require the auditor to consider whether to include information on:

— audit differences that have not been adjusted (whether or not they result in a qualified audit opinion);

— audit differences that have been adjusted in the final financial statements; or

— control weaknesses identified in a focus area where the audit approach was mainly controls testing.

So there can be some value in binary findings, and for some they might also represent a step on the way to graduated findings. Of course, the choice should be made before the final audit commences. That way it will be clear that a company's choice is free of any question of bias based on knowledge of the audit findings.

> "As a result of our work, we determined that the quantum of impairment recognised in 2015 was appropriate. For those intangible assets, where management determined no impairment was required, we found that these judgements were supported by reasonable assumptions."
>
> *KPMG LLP, report to the members of Smith & Nephew plc*

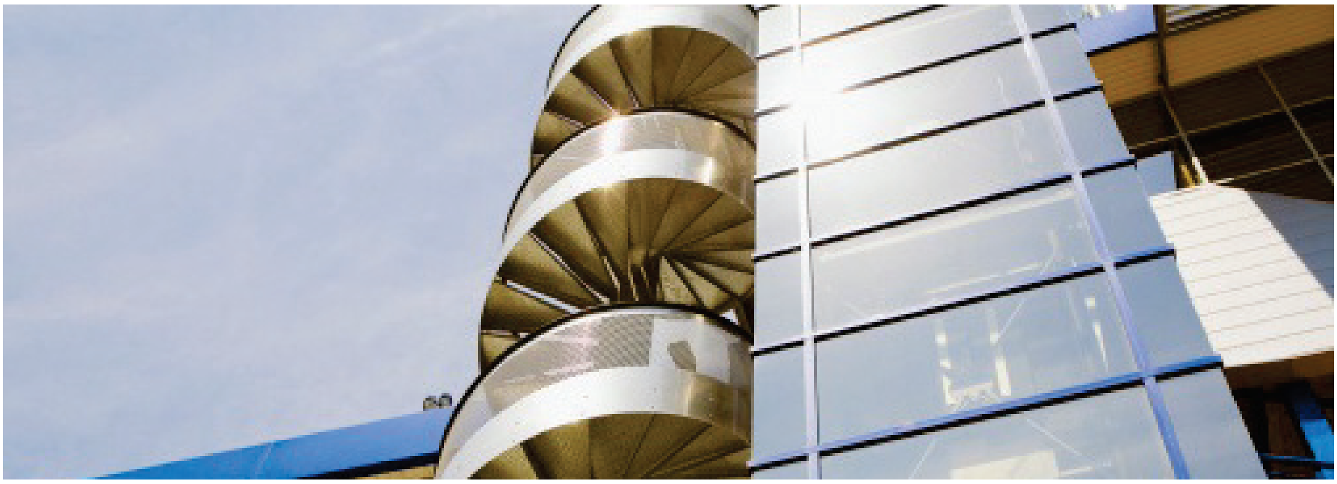
3 Graduated findings

Although take-up has been limited to only eight listed companies, the graduated findings approach continues to receive positive feedback from the investment community. This approach details the result of audit tests in the key risk areas – typically about significant judgments, such as accounting policies, or estimates where there is a range of acceptable outcomes – in more specific terms than acceptable/ unacceptable. For example, estimates within a range might go from "optimistic" to "cautious" with a "balanced" mid-point, which is the weighted reporting that auditors have provided to audit committees for many years. So it provides shareholders with a more nuanced understanding of the audit and of the professional judgments weighed up in arriving at the audit opinion on the accounts as a whole.

Views differ on the merits of this approach. For example, some see this as something that the audit committee should report or perhaps the company itself in the accounts. Nevertheless, better stewardship relationships between companies and their shareholders are in everyone's long-term interests, and it can be argued that the highest level of audit reporting helps to put that relationship, in which the annual accounts are a key feature, on a more solid foundation of trust.

> "In determining the appropriateness of the rebates, chargebacks and returns deductions in accordance with contractual and regulatory requirements, there is room for judgement and we found that within that, the Group's judgement was balanced (2014: balanced). We found the assumptions used and the resulting estimates to be balanced (2014: balanced). We also found no errors in the year-end rebate accrual calculations. We found the disclosures on rebates, chargebacks and returns to be proportionate."
>
> *KPMG LLP, report to the members of AstraZeneca PLC*

> "We found the resulting estimate of the recoverable amount to be mildly optimistic and the Group's disclosures with regards to the impairment testing for the HDSA receivable to be proportionate in their description of the assumptions and estimates made by the Group concerning the value of its underlying collateral.
>
> *KPMG LLP, report to the members of Lonmin Plc*



4 Risk map

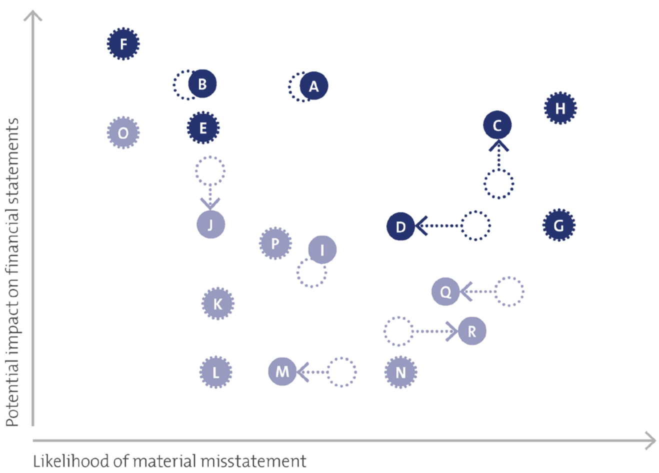
This year, a small number of reports, have included greater insights into audit planning by listing not only the risks, how they arise and how they have been addressed, but also risks that were not quite significant enough to merit full explanation in the audit report.

This has been presented in the way that auditors typically report on audit planning to the audit committee, by putting the risks against a scale of potential impact and a scale of likelihood of material misstatement. The resulting "risk map" enables shareholders to see not only the other key matters that received attention but how close those matters were to being among the most significant risks.

Showing this dynamic planning tool also provides a more immediate way to communicate changes in risk assessment since the previous year.

When taken together with the reporting of graduated findings, the resulting picture of the audit will provide shareholders with a greater understanding of what lies behind the binary opinion on the accounts as a whole – an end-to-end picture of the work done on their behalf to arrive at that opinion.

> **Dynamic Audit planning tool**



- A The pressure on and incentives for management to meet revised revenue and profit guidance
- B The basis of accounting for revenue and profit in the Civil Aerospace business
- C The measurement of revenue and profit in the Civil Aerospace business
- D Recoverability of intangible assets in the Civil Aerospace business
- E Liabilities arising from sales financing arrangements
- F Bribery and corruption
- G The presentation of 'underlying profit'
- H Disclosure of the effect on the trend in profit of items which are uneven in frequency or amount
- I Measurement of revenue and profit on long term contracts outside the Civil Aerospace business (see page 115)
- J Determination of development costs to be capitalised (See page 115)
- K The basis of accounting for contractual aftermarket rights (see page 113)
- L Determination of the amortisation period of development costs and CARs (see page 119)
- M The basis of accounting for Risk and Revenue Sharing Arrangement (see page 114)
- N Estimating provisions for warranties and guarantees (see page 116)
- O Valuation of derivatives and hedge accounting (see page 118 and 119)
- P Measurement of post retirement benefits (see page 115)
- Q Accounting for uncertain tax positions and deferred tax assets (see page 116)
- R Valuation of goodwill (see page 115)

KPMG LLP, report to the members of Rolls-Royce Holdings plc

How far do the EU rules move reporting?

For years commencing on or after 17 June 2016 the EU audit reforms will require auditors to report the risk, the response and "where relevant, key observations". This will also be implemented in the FRC's auditing standards. It will apply only for public interest companies. These are companies with securities admitted to trading on an EU regulated market – e.g., the main market of the London Stock Exchange, and equivalent markets elsewhere in the EU – and unlisted banks and insurers.

> The audit report shall 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 due to fraud;
>
> II. a summary of the auditor's response to those risks; and
>
> III. where relevant, key observations arising with respect to those risks.
>
> *EC regulation 537/2014, article 10(2)(c)*

For such companies, how far along the journey does this require audit reporting to go? Answering that is also an opportunity to reflect on progress since 2013 and to decide where next. It is beyond any one firm to be able to decide that, and the FRC's latest draft standards leave the question unanswered. It is more properly a question for affected stakeholders than for auditors. Consensus and codification are required:

— Does "observations" mean graduated findings, binary findings, or something else?

— When might observations be "relevant" – always, or only in specific circumstances?

— What do companies see as being in the best interests of their relationship with their shareholders?

— What will shareholders expect?

— How will the audit regulator regulate this?

This is too important a challenge and opportunity not to be publicly debated. We encourage the investment community and companies to make their views known.

Contact us

Timothy Copnell
Audit Committee Institute
T: +44 (0)20 7694 8082
E: tim.copnell@kpmg.co.uk

kpmg.co.uk/aci