



The enhanced auditor's report – bulletin 1

A review of the first reports for early adopters

Background

The new requirements of ISA (UK & Ireland) 700 *The auditor's report on financial statements* apply for years ending on or after 30 September 2013.

For entities adopting the UK Corporate Governance Code, this opens the black box of audit to discuss the assessment of risks and materiality and how these are addressed by the auditor.

Three companies agreed with their auditor that they would adopt these changes early. Vodafone's 31 March 2013 audit report was based on the FRC's exposure draft. The revised standard was issued in June 2013 and was adopted for the 30 June 2013 audit reports for BSkyB and Ashmore.

This bulletin highlights the key areas emerging from the reports issued to date. Our second bulletin will update this preliminary analysis with the benefit of 30 September year end reporting.

Summary

Enhanced auditor's reports include a number of new requirements alongside the pre-existing elements of the financial statement opinion, other opinions driven by legal requirements and matters reported by exception. Areas to look out for in the enhanced auditor's report include:

- Audit risks: The auditor is required to discuss the risks of material misstatement that had most effect on the conduct of the audit.
- Materiality used by the auditor in the conduct of the audit. Although not required by the standard, all three early adopters also reported the level at which errors identified are reported to the Audit Committee.
- Scope of audit work undertaken, including responses to audit risks.

Recent requirements of the UK Corporate Governance Code mean that the Audit Committee is now expected to discuss in their report significant issues relating to financial reporting under provision C.3.8. This dovetails with the auditor's requirement to discuss the risks of material misstatement that had most effect on the conduct of the audit.

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Analysis of audit reports

The tables below compare the treatment of the principal new areas in the new style auditor's report, showing how they have been dealt with by the auditor for each of the three early adopters. Below the tables we highlight the key take-aways from the new auditor's reports issued to date. All page references are to the relevant Annual Reports.

1) Layout and basic information

	Vodafone	BSkyB	Ashmore
Year ended	31 March 2013	30 June 2013	30 June 2013
Date of signature	21 May 2013	25 July 2013	9 September 2013
Audit firm	Deloitte	Deloitte	KPMG
Signed before or after standard issued	Before	After	After
Location and length of opinion	88-89 (2 pages)	61-62 (2 pages)	67-69 (3 pages)
Going concern comment	Separate opinion	Separate opinion	Report by exception only

Both the Vodafone and BSkyB auditor's reports include a separate opinion by the auditor on going concern which went above and beyond the review required by the Listing Rules. Whilst not required by the Listing Rules or by ISA (UK & Ireland) 700, our view is that a separate opinion on going concern is helpful to shareholders – in the spirit of the recommendations of the Sharman inquiry it demonstrates the auditor's active consideration of going concern as part of the audit.

The Vodafone and BSkyB auditor's reports separate the description of the risks of material misstatement from the way the auditor scoped the response to these risks, following the example given in ISA (UK & Ireland) 700. The Ashmore report discusses the risks and the approach to the audit of the risks in the same section, which may be more helpful to the reader and, given that this is the direction of travel for the international proposals on auditor reporting, we expect this to become the norm.

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2) Risks of material misstatement identified in the auditor's report

	Vodafone	BSkyB	Ashmore
Number of risks	5	3	4
All risks discussed by the auditor also mentioned in the Audit Committee report?	No (page 62)	Yes (page 43)	Yes (page 47)
All areas of focus from the Audit Committee report included as risks in the auditor's report?	Yes	Yes	No
Auditor includes reference to the pages of the Audit Committee report?	Included, one reference	Included, one reference	Included, separate reference per risk
Level of description given in the auditor's report for response to risks	Concise, single bullet-point	Concise, single bullet-point	Discursive paragraphs
Testing of controls described as part of auditor's response to risks?	One risk	Two risks	One risk
Assessment of disclosures described in response to risks?	Yes	No	Partial (for 2 out of 4 risks)

We believe that good communication is likely to be concise and to the point.

We expect practice to evolve such that there is a level of interplay between the risks discussed in the Audit Committee report, those raised in the auditor's report and the critical accounting judgements and key sources of estimation uncertainty. In particular, we anticipate that the majority of Audit Committee reports will present either the same number of risks or more risks than the auditor's report. This will reflect both the individual circumstances of the company and the fact that the Audit Committee may be including risks relating to future accounting that are not material to the current financial statements, or risks relating to narrative reporting.

The detailed responses to risks in the auditor's report so far vary significantly by entity and indeed by risk, as shown above. As would be expected, the type of work performed by the auditor in response to the risk will vary because by definition such risks are specific to the entity. There is some variation in the extent of description of the work performed. We believe that good communication is likely to be concise and to the point.

Many responses focus entirely on substantive procedures, including detailed substantive testing, reference to recalculation, inspection of documentation, and explanation of the challenge offered to management judgements and assumptions by the auditor. Testing of controls is mentioned more rarely and we believe this does not reflect an absence of testing of controls, but instead that substantive testing forms a greater part of the testing mix where there is a significant audit risk.

However, we do expect to see more mention of controls where audited companies are listed in the USA, given the Securities and Exchange Commission requires the auditor to test and provide an opinion on internal controls over financial reporting. The FRC's proposed changes to the UK Corporate Governance Code issued for consultation in November 2013 may lead future auditor's reports for companies listed in the UK in the same direction.

3) Materiality

	Vodafone	BSkyB	Ashmore
Materiality	Yes; £500m	Yes; £50m	Yes; £13m
Materiality compared to pre-tax profit?	Yes; 5% of adjusted pre-tax profit	Yes; 4% of adjusted pre-tax profit	No percentage given
Materiality compared to equity?	Yes; 1% of equity	Yes; 5% of equity	No
Explanation given of "adjusted" pre-tax profit measure used?	Yes	Yes	N/A
Materiality for component audits?	Yes	N/A	Yes
Quantitative level at which audit differences reported?	Yes; £10m	Yes; £2.5m	Yes; £0.65m
As a % of materiality?	2%	5%	5%

The Vodafone and BSkyB reports include a percentage comparison to pre-tax profit and to equity, which we think is helpful in putting materiality into the context of the financial statements.

The Ashmore report explains the relevance of the pre-tax profit measure used to calculate materiality as "most used by members in assessing financial performance." We expect to see more such explanations in future, primarily where measures used to assess financial performance are close to the IFRS measures, but these may not be the same as performance measures used by analysts.

Although it is not a requirement of the standard to provide the level at which errors identified are reported to the Audit Committee, this measure has been provided by all three reports so far. The quantitative level at which differences are reported to the Audit Committee has been between 2% – 5% of materiality. This is informative because it helps users understand that auditors are concerned with amounts at a lower level than the materiality figures reported.

None of the auditor's reports have presented the quantum of overall audit differences or disclosure deficiencies, nor have the Audit Committee reports mentioned unadjusted differences. Investor representatives have mentioned to us that they may make enquiries of Audit Committees on this as part of their audit quality enquiries.

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4) The scope of the audit

	Vodafone	BSkyB	Ashmore
Level of coverage explained	Yes	Yes	Yes
Measures used to explain level of coverage	Total assets; revenue; operating profit	Total assets, revenue, operating profit	Total assets, revenue, profit before taxation
Group auditor involvement in work of overseas audit firms explained	Yes; including visits to key locations	N/A	No
Statutory audits mentioned	Yes	No	No

There are substantial differences in the both the amount of description and the nature of the audit scope provided in these early adopters. As each company is unique we expect this scope description also to be unique.

As shown above, all auditors so far have given an useful description of their audit coverage.

The Vodafone report explains the group auditor's involvement in the work of overseas audit firms, including visits by the group audit team to key locations.

Future trends

We expect the following areas to become matters of increasing interest in the international debate over the auditor's report:

- reporting on the auditor's independence, which although confirmed in the UK in the heading of the auditor's report is a topic of discussion internationally; and
- timeliness of the auditor's report, given that the market focuses principally on the preliminary announcement and the annual report represents a stewardship report published later. The preliminary announcement does not currently include any details from the new style auditor's report.

The auditor's report is evolving at pace and we will share our analysis with you regularly.

Location of reports

The annual reports referred to in this analysis can be accessed by clicking on the links below:

- [Vodafone](#)
- [BSkyB](#)
- [Ashmore](#)

Further information

Other UK accounting, reporting and corporate governance news and publications can be found at:

www.ukaccountingplus.co.uk

If you would like to discuss any issues raised in this publication, please contact your usual Deloitte partner or:

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