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The enhanced auditor’s report – bulletin 2
A review of the latest auditor’s reports

Background

The new requirements of ISA (UK and 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 (the Code).

The enhanced auditor’s report – bulletin 1 offered a preliminary analysis of the key areas emerging from auditor’s reports on three early adopters, Vodafone, BSkyB and Ashmore.

In this bulletin we consider how the auditors’ reports on the first companies for which the new report is mandatory discussed the auditor’s assessment of risks, materiality and scoping.

We have read the audit reports for 37 companies, of which 12 are investment trusts. Our analysis focuses on the 25 non-investment companies and we comment briefly and separately on investment trusts.

Summary

This bulletin shows that there has been significant evolution in auditor reporting, with the enhanced auditor’s report giving new insight into the work of the auditor.

Auditors’ reports are not issued in a vacuum and should be read in conjunction with the audit committee’s description of the significant issues related to financial reporting which they have considered (Code Provision C.3.8).

The majority of audit committees included information about their interaction with the auditor on those significant issues; in turn almost all auditors’ reports cross-referred to the discussion in the audit committee’s report. This is encouraging as it indicates that there is already good engagement in the structuring of the overall narrative.

In this bulletin we discuss the main areas covered by the auditor’s report, identify some differences between the approaches taken by the firms and consider emerging trends, including:

- inclusion of a positive statement on going concern;
- presentation of risks and responses;
- the risks most commonly identified by the auditor; and
- the interaction between the number and nature of the risks and responses identified by the auditor compared to the significant issues identified by the audit committee.

There is variation in practice which we expect to evolve further over the course of 2014. We expect that UK experience will also influence practice elsewhere as we move towards a global standard on enhanced auditor reporting.

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Analysis of auditor's reports

1) General approach

Length of report

With the new enhancements required by the revised ISA (UK and Ireland) 700, the average length of an audit report has now increased to three pages. Given this increase, it is not surprising that the past practice of issuing separate audit reports on group and company only financial statements is dying out, with only a third of annual reports now including two auditors' reports. Our view is that as the reporting requirements are now similar, it is preferable to issue a single audit report covering the group and the company, whether or not they are prepared under the same GAAP.

Most enhanced auditor's reports provide an up-front audit opinion and then finish with the majority of the other opinions, which largely consists of matters on which the auditor is required to report by exception. Unfortunately, the nature of the underlying UK legal requirement and the wording in ISA (UK and Ireland) 700 does not provide any way to simplify and streamline this material, which can seem like "boilerplate" and confusing to the reader.

We have suggested to the Department of Business, Innovation & Skills and the Financial Reporting Council (FRC) that it may be worth looking at these duties again; for example, in Ireland auditors express a positive opinion as to whether proper books of account have been kept – see **Greencore Group plc** (KPMG).

Going concern

All audit reports issued by Deloitte and PwC have included a separate opinion by the auditor on going concern. This is the majority of auditors' reports issued to date. None have reported material uncertainties regarding the going concern basis of accounting.

Our view is that a separate, positive opinion on going concern gives genuine clarity to shareholders. Although it is not required by the Listing Rules or by ISA (UK and Ireland) 700, 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 and leaves no room for ambiguity over the auditor's conclusion. The International Auditing and Assurance Standards Board (IAASB) plans to mandate a going concern conclusion for all entities as part of their proposals for international reporting.

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Risk and response

Unlike the example issued by the FRC to accompany the new standard, a majority of auditor's reports now link the identified risks with the related audit responses in one section of the report. We think this is more helpful to the reader and expect it to become the norm. Just over half of these reports use a tabular format, showing the risk on the left hand side and how the risk has been addressed on the right hand side. This is easy to read and where it suits the style of the rest of the annual report we consider it a good way of presenting the auditor's approach discussion.

Deloitte view

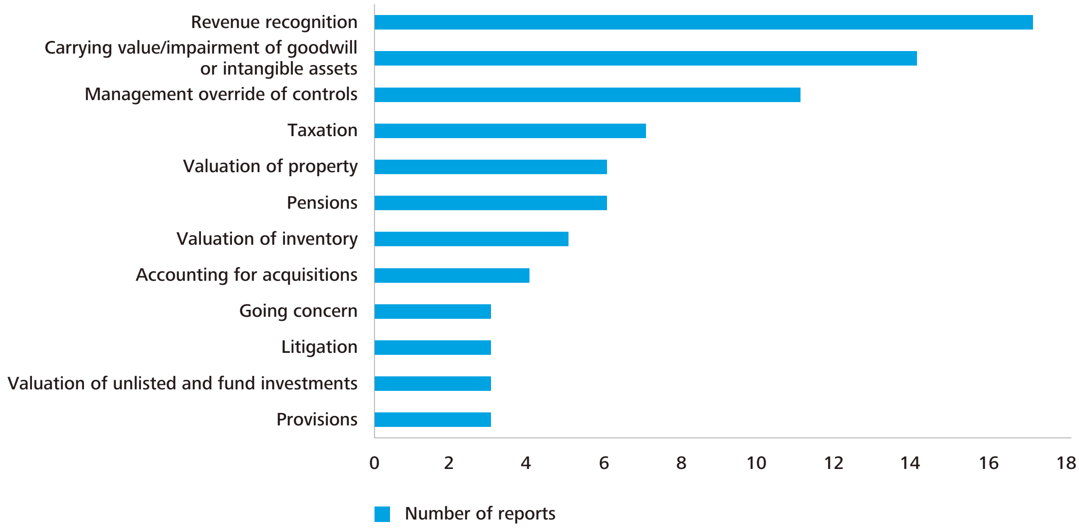
- **It is preferable to issue a single report covering both the group and the parent company.**
- **There would be a benefit to the regulator revisiting elements of the pre-existing audit report to identify areas where changes to the law and standards could make reporting simpler, more streamlined and more company-specific.**
- **A separate opinion on going concern leaves no room for ambiguity regarding the auditor's conclusion and is in line with the spirit of the Sharman inquiry. This should become a compulsory feature of the standard in the UK and Ireland.**

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

The risks of material misstatement identified in the auditor's report are "those assessed risks of material misstatement that… had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team."

This leads to some differences in interpretation around how auditors determine which risks to mention in the auditor's report. We would nonetheless expect a level of consistency between entities in the same sector, whilst recognising that the auditor's description should be tailored to the entity in question rather than becoming boilerplate. The emerging trend is to identify why the auditor considers these risks to have had the greatest effect – this is in line with the expected requirements of the forthcoming IAASB standard and it makes the auditor's discussion more useful to shareholders by explaining why the auditor focused on those particular areas.

The table below shows the incidence of particular risks in the 25 enhanced audit reports we have read (excluding investment trusts) where the risk occurs more than twice.



One difference which can be seen between firms' approaches to their report is whether or not to include the 'default' risks set out in ISA (UK and Ireland) 240 – a presumed risk of fraud in revenue recognition and a mandated risk of management override of internal controls. The high incidence of management override of controls among reported risks appears to be likely to be due to firms deciding to include this risk in their reports by default: nine instances of the risk appeared in PwC reports. The IAASB's exposure draft suggests that it is more likely that auditors will refer to those risks specifically identified in the context of the entity, rather than to those that have been so identified only because they are presumed in the ISAs to be significant risks, and this may influence the decision going forward.

This is not to say that revenue recognition and management override will never be specifically identified in the context of the entity, for example **TUI Travel plc** (PwC) draws out company-specific circumstances for the risk of management override of internal controls and describes the audit work carried out in response.

Trends may evolve over time, and as more reports are issued, there may be more apparent similarity in the way firms discuss particular issues. We believe it is vital that risks, the reasons why they are risks and the associated responses remain as company-specific as possible and do not become boilerplate.

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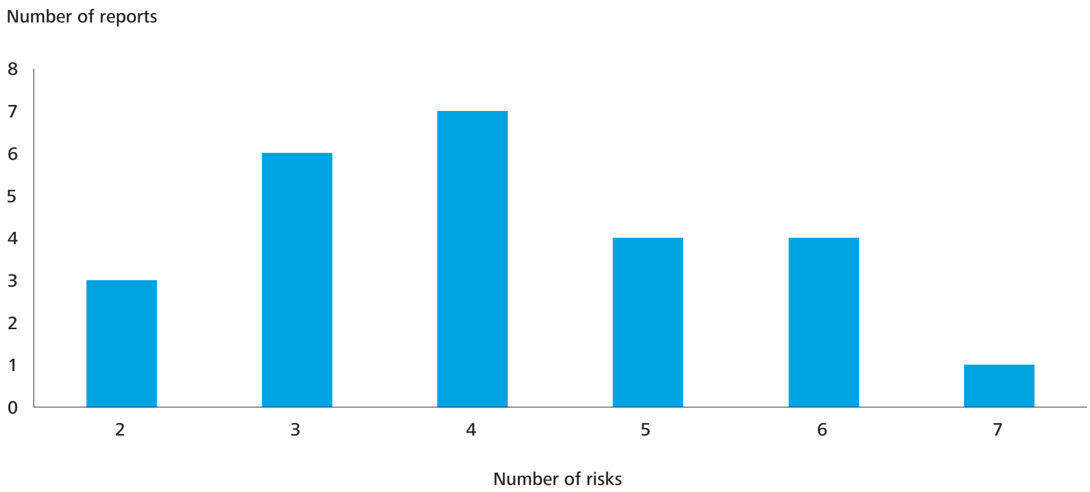
The table below shows the number of risks reported by the auditor for entities other than investment trusts. The average (both mean and mode) is four risks; due to rounding, the mean is still four risks even if management override of controls is excluded.



As would be expected, the number of risks tends to be associated with the complexity of the audited businesses, although there are outliers in both directions.

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The detailed responses to risks in the auditor's report vary significantly by entity as well as by risk. The type of work performed by the auditor is driven by the specific entity risk and there is variation in the extent of description of the work performed. We believe that good communication is likely to be concise and to the point.

Interaction with the audit committee's report

The auditor's requirement to discuss the risks of material misstatement that had most effect on the conduct of the audit dovetails with the audit committee's new requirement under the Code to discuss in their report significant issues relating to financial reporting. There is also some interaction with parts of the financial statements, notably the key sources of estimation uncertainty, and with the principal risks and uncertainties in the strategic report. The average number of significant issues disclosed by the audit committee was also four (see our recent publication **It has begun: Early examples of reporting practice**).

The majority of audit committees refer to their interaction with the auditor around significant issues relating to the financial statements; in turn, almost all auditor's reports provide a cross-reference to the audit committee's discussion of significant issues.

When comparing the matters identified as significant issues in the audit committee report and the auditor's risks of material misstatement:

- Just under half of the companies omitted at least one of the auditor's risks of material misstatement; however these were generally either management override of controls, as discussed above (ten companies) or revenue recognition (eight companies). Excluding these, only two companies did not discuss one of the risks identified by the auditor.

- Two companies in our sample mentioned management override of controls as a significant issue considered by the audit committee. In both cases the context given was the auditor's work on the subject. For one of these companies, the auditor had not identified management override as a risk meriting discussion in the auditor's report.

- A small majority of companies raised additional significant issues in the audit committee report over and above the risks of material misstatement identified within the auditor's report. This was most commonly restricted to one issue (six companies).

- The most common significant issues raised by the audit committee and not by the auditor were treatment of exceptional or unusual items in the financial statements (six companies), taxation (three companies), going concern (three companies) and accounting for material transactions (two companies). There were also examples of companies describing the same general issues as the auditor but providing more breadth or touching on areas that the auditors did not discuss, for instance **Euromoney Institutional Investor plc** (Deloitte). An example of this difference in level of description of the risk around revenue recognition is shown below.

Risk in enhanced auditor's report	Audit committee significant issue
Revenue recognition, including deferred income on subscription and delegate revenue.	Revenue recognition in relation to the cut-off for publications and events, the deferral of subscription revenues and the treatment of voting and commission share agreement revenues.

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Where investment trusts are not in distress, they are comparatively straightforward businesses. The majority of risks identified, as expected, related to valuation of the investment portfolio (listed and unlisted), existence of investments, revenue recognition related to dividends and management override of controls.

Most audit committees mentioned additional significant issues over and above the risks of material misstatement identified in the auditor's report. These were most commonly misappropriation of assets, revenue recognition, compliance with tax law and going concern.

Deloitte view

- Auditors should identify to the shareholder not only the risk, but why they believe it is a risk.
- Descriptions of risks and responses should be entity-specific and as long as sufficient information is provided, there is merit in being concise.
- We expect to see further evolution in the interactions between the auditor's report, the audit committee report and elements of the financial statements.

3) Materiality

The description of materiality in the majority of audit reports included a percentage comparison to pre-tax profit; fewer than half compared materiality to equity or other measures. We think the comparison is helpful in putting materiality into the context of the financial statements. It may be useful to readers of auditor's reports to refer to the FRC's **thematic review on materiality** which provides some insight into the different approaches taken by firms in this area.

Some audit reports provided extensive explanation of the key measure used to determine materiality, in some cases where the measure used was less usual (for instance, operating profit – see **TUI Travel plc** (PwC) and in some cases to explain the use of an underlying measure of pre-tax profit, for instance **Britvic plc** (Ernst & Young).

One investment trust, **Finsbury Growth and Income Trust PLC** (Grant Thornton), described using a lower level of materiality for work performed on the income statement.

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 but one report in our sample. The quantitative level at which differences are reported to the audit committee was between 2% and 9% of materiality.

Two reports identified performance materiality, which is only a suggestion in the guidance to the standard. In their **feedback statement** issued with the standard, the FRC explained that there was no requirement to communicate performance materiality and "it is for the auditor to ensure that the description of how the concept of materiality has been applied is communicated in a manner that is readily understandable by users." Performance materiality is used to determine the extent of testing and is lower than planning materiality to reflect the auditor's assessment of the risk of undetected or uncorrected in the financial statements. However, performance materiality is a complex concept and rather than being generally informative, will mainly reflect the methodology and sampling approach of an individual firm. Performance materiality in these two reports was identified as 75% and 50% of materiality.

We believe that an unusually high or low level of performance materiality for a particular audit could be of interest to shareholders but will not be useful without a clear explanation of why performance materiality has been set at that level.

None of the auditor's reports have presented the quantum of overall audit differences or disclosure deficiencies. The audit committee of **Lonmin plc** (KPMG) discussed misstatements but did not indicate whether there were immaterial 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 and the FRC is considering recommending that audit committees make a statement regarding the booking of identified adjustments.

Deloitte view

- **The comparison of materiality to pre-tax profit or other relevant measures in the financial statements is helpful to the reader.**
- **Although not required by the standard, it is important to share the quantitative level at which differences are reported to the audit committee.**
- **Reporting of performance materiality will be useful only where there is a clear explanation of why it has been set at a certain level.**

The quantitative level at which differences are reported to the Audit committee was between 2% and 9% of materiality.

4) The coverage and geographic scope of the audit
There continue to be significant differences in both the extent of the description and nature of the audit scope reported. We consider that to be an appropriate approach given that each company, and the scope of each audit engagement, is unique.

A majority of the audit reports we read gave a description of audit coverage which referred to percentage coverage of measures in the financial statements, usually revenue, operating profit, profit before tax or net assets. Some supplemented this coverage with discussion of statutory accounts audit work. Both of these may help the reader put the level of audit work into context, whilst recognising that the statutory audit work on subsidiaries may be more dependent on geographic distribution than the requirements of the group auditor.

Use of component auditors
Where the group auditor uses overseas audit firms, we consider it is important to explain the way the group auditor has scoped the engagement and ensured they have sufficient appropriate oversight of and involvement in the work of component audit teams. In the majority of cases there was some description given. This varied between a simple mention that involvement with overseas teams was considered, without a description of the actual involvement of the group team, to reports which provided greater detail on the group auditor's approach.

Examples of detail disclosed to demonstrate the group auditor's approach included:

- descriptions of visits to components by the senior statutory auditor or other members of the group team;
- other meetings relating to locations not physically visited;
- attending meetings with the component auditor and local management, such as close meetings;
- the nature of matters discussed with the component auditor;
- review of documentation; and
- briefings provided by the group team to the component auditor.

Good examples include **Lonmin plc** (KPMG) and **Compass Group plc** (Deloitte).

Deloitte view

- **Additional description of audit scope can be more informative where a level of coverage is reported, compared to a relevant financial statement measure.**
- **It is important for the auditor to draw out their involvement in audits performed by overseas component auditors as this helps the shareholder to understand how the auditor has become satisfied with the work of these audit teams.**

There continue to be significant differences in both the extent of the description and nature of the audit scope reported.

Conclusion
Over the last six months we have already seen a significant degree of evolution in practice in the auditor's report and we expect to see further changes for 31 December year ends, as audit firms gain more confidence in applying the standard.

We welcome thoughts and input regarding our points of view expressed in this bulletin.

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:

Simon Letts
sletts@deloitte.co.uk

Richard Gillin
rgillin@deloitte.co.uk

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