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INDEPENDENT AUDIT LIMITED

FRC Consultation on Changes to the Auditor's Report

Audit Review: **TECHNICAL NOTE**

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David trained as a Chartered Accountant at the London office of Arthur Andersen (now Deloitte). Following a spell in investment banking, he became finance director of a London Stock Exchange premium -listed company. In this latter role he was a major user of the audit services and non-audit services of a “Big 4” firm as well as having oversight of internal audit. He combines his role at Audit Review with a number of non-executive directorships and is chairman of the audit committees of two sizeable insurance companies.

David is a Fellow of The Institute of Chartered Accountants in England & Wales and an Associate of the Chartered Institute of Taxation. He is deputy chairman of the ICAEW’s NED Group, for whom he regularly lectures on corporate governance issues.

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Introduction

On 4 June 2013, the Financial Reporting Council ('FRC') published revisions to ISA (UK and Ireland) 700 covering the auditor's report for entities which are subject to the UK Corporate Governance Code ('the Code'). This requires the auditor's report to address three new critical areas: risks of material misstatement, materiality and the audit scope.

When do the new provisions apply?

The effective date is for reporting periods beginning on or after 1 October 2012, to bring them in line with the other Code changes recently implemented.

Overview of changes and rationale

The changes will only apply to the auditor's reports of those entities that report on how they have applied the Code. This includes all companies with a premium listing on the London Stock Exchange, but also those other entities which choose voluntarily to apply the Code.

The auditor's report is required to include three new disclosures

→ A description of the risks of material misstatement that were identified by the auditor and which had the greatest effect on
  – the overall audit strategy
  – the allocation of resources in the audit
  – directing the efforts of the engagement team

→ An explanation of how the auditor applied the concept of materiality in planning and performing the audit

→ A summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement and the auditor's application of the concept of materiality, as disclosed in the auditor's report.

The auditor should determine which risks of material misstatement should be described and these need not be the same as the 'significant risks' which are covered by the ISAs.

These changes are viewed by the FRC as complementary to the changes made in the September 2012 revisions to the Code which require the auditor to enhance communications with the Audit Committee and to report to shareholders by exception if the auditor does not believe the annual report and accounts taken as a whole are fair, balanced and understandable. These changes focus more on the 'inputs' to the scope of the audit, rather than the 'outputs' and have emerged from views and discussions with stakeholders in the audit process. In particular, the FRC notes that the provision of information on audit scope received support from investors.

Issues arising from the consultation

The FRC conducted an extensive consultation on the changes, including a public meeting held in March 2013, as well as an outreach programme with UK and US investors, the accounting Institutes and audit firms. A fairly high proportion (5 out of 31) disagreed with the proposals, so they are not uncontroversial. However, the majority of respondents were "on balance supportive of the proposals". Whilst the main thrust of the proposals have therefore been adopted, some useful drafting changes have been made and a revised ISA 700 issued.

Detailed proposed changes

A new paragraph 19A has been added to ISA 700 which requires the auditor's report for those entities which are required or choose voluntarily to report on how they have applied the Code to:

(a) Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;

(b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole (as required by ISA 320 "Materiality in planning and performing an audit"); and

(c) Provide a summary of the audit scope (as referred to in ISA 260 "Communication with Those Charged with Governance*"), including an explanation of how such scope addressed the assessed risks disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b).*

In an attempt to avoid auditors adopting standardised language, or more 'boilerplate' to put it in the vernacular, the proposed revisions seek to introduce some principles and guidance for the auditor in a new paragraph 19B.

A new A13A guides the auditor to consider whether to disclose the facts and circumstances if the auditor significantly revises its risk assessment during the audit.

A new A13B provides guidance on the explanation of how the auditor applied the concept of materiality in planning and performing the audit. The explanation should be tailored to the particular circumstances and complexity of the audit and specify the threshold used by the auditor as being materiality for the financial statements as a whole. It might also include

- → Materiality level or levels for those classes of transactions, account balances or disclosures where such materiality levels are lower than materiality for the financial statements as a whole
- → Performance materiality[1]
- → Any significant revisions of materiality thresholds that were made as the audit progressed
- → The threshold used for reporting unadjusted differences to the Audit Committee
- → Significant qualitative considerations relating to the auditor's evaluation of materiality.

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[1] 'Performance materiality' is defined in ISA 320 and is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole.

A new A13B provides guidance on the explanation of how the auditor applied the concept of materiality in planning and performing the audit. The explanation should be tailored to the particular circumstances and complexity of the audit and specify the threshold used by the auditor as being materiality for the financial statements as a whole. It might also include

Finally, a new A13C provides guidance on the disclosure relating to the summary of the planned scope of the audit. It should be tailored to the particular circumstances of the audit and how the planned scope was influenced by the auditor's application of materiality and was responsive to the assessed risks. This might also include

- → The coverage of revenue, total assets and profit before tax achieved
- → The coverage of revenue, total assets and profit before tax of reportable segments achieved
- → The number of locations visited by the group auditor as a proportion of the total number of locations and the rationale underlying any programme of visits
- → The effect of the group structure on the planned scope (the audit approach to a group consisting of autonomous subsidiary companies may differ from that applied to one which consist of a number of non-autonomous divisions)
- → The nature and extent of the group auditor's involvement in the work of component auditors (which may not be audited by the group auditor's network firm).

Audit Review Comment

These changes are a further response to increasing interest by investors and other stakeholders in the quality of the audit and the usefulness of the audit report. If properly adopted, we believe they will continue to help reinforce investors confidence in a robust and independent audit.

Many investors have commented that auditors' reports currently contain largely standardised language. Some investors believe that further company-specific information will provide a 'hook' on which they could start a useful dialogue with a company. We concur with the FRC's belief that this may help close any audit expectation gap and the consultation paper contained a selection of investors' responses to back this viewpoint.

Boards and Audit Committees expressed the view that to make these new disclosures in their report would be uncomfortable as this is seen most naturally in the auditor's domain and appropriate for such information to be disclosed in the auditor's report. Auditors have, not surprisingly, raised the potential risks to them in moving away from a binary audit opinion.

We believe the additional disclosures around audit focus should provide a useful trigger for Audit Committees and boards to ensure that material issues are disclosed and discussed in the financial statements, the operating and financial review or the Audit Committee report. As such, they could provide useful additional information for investors and better hold boards and Audit Committees to account. However, we expect concise descriptions of how audit materiality is derived to prove challenging. The additional disclosures are usually those which we already report to our clients on when we are engaged to provide an Audit Effectiveness Review.

We expect that, where investors engage with companies and their auditors, attention will fall on levels of both materiality and the level of uncorrected misstatements. In our experience, the level of misstatements, which are often currently unadjusted in the financial statements, can be material in the context of stock market forecasts. We believe it will become essential for Audit Committees to adopt a written policy for when it expects misstatements to be corrected in the financial statements.

Crucially, greater transparency of materiality levels will allow benchmarking against comparable companies and promote more informed debate between Audit Committees, management and all stakeholders in an important area which has, hitherto, been virtually hidden from view.

It is vital that the new disclosures which are expected from auditors are 'company specific' and will only be of use if auditors resist the temptation turn the disclosures into formulaic standardised additional paragraphs. In our view, investors and other stakeholders will need to follow through on their apparent wish to trigger further discussions with companies on their audits for the additional disclosures not to become further boiler plating.

These changes add to the responsibilities falling upon Audit Committee Chairs. Whilst audit committee chairs have not, yet, achieved the prominence accorded to the remuneration committee chairs, these changes will increase the public attention directed at the role.

The implementation of these changes for accounting periods which have already begun mean that the audit profession and Audit Committees need to consider very quickly the impact of these changes on their year-end timetables. However, we have been pleased to see that Vodafone Group Plc and its auditors, Deloitte, have early-adopted the changes in their accounts for the year ended 31st March 2013, published very soon after the new ISA. It is interesting to note that the new-style audit report takes two full sides of A4 in fairly small print.

The changes apply not just to listed companies, but to other ‘entities which report on how they have applied the Code’. The Code is and should be used as a best practice standard by many private companies and public sector and not for profit organisations. Auditors may need to seek formal confirmation from those entities as to whether they apply the Code. This may have the unintended consequence of making some entities dis-apply the Code, possibly encouraged by their auditors, in order not to have this greater disclosure applied.

Further Reading

ISA (UK and Ireland) 700 (Revised) The independent auditor’s report on financial statements

http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-%28UK-and-Ireland%29-700-%28Revised%29.aspx

Feedback Statement on consultation on proposed revision to ISA (UK and Ireland) 700 requiring the auditor’s report to address risks of material misstatement, materiality and a summary of the audit scope FRC June 2013

http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Consultation-Paper-Revision-to-ISA-%28UK-and-Ireland/Feedback-Statement-proposed-revision-to-ISA-%28UK-an.aspx

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