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New insightful audit reports

January 2015

An overview of the new global auditor reporting model

Contents

Time for informative, insightful auditor reporting

The new auditor's report is here. After three years of development, the International Auditing and Assurance Standards Board (IAASB) has released a set of standards that we believe are truly game-changing for shareholders and the profession.

Implementation will bring both opportunities and challenges.

The standards mark a move to reports that are more informative, discursive and insightful. The new reports will undoubtedly stimulate enhanced conversations among auditors, companies, audit committees, shareholders and regulators.

We believe that the more informative reports and dialogue will demonstrate more visibly the value and relevance of audit. Relevant reports from a relevant profession – that's the opportunity.

So far, the forerunners have been on the right track. Where similar proposals have been rolled out in the UK, auditors have embraced the transformation – producing insightful reports with tailored information and less jargon. Shareholder reaction has been very positive, referring to a 'sea change' in auditor reporting. This is a good start.

While the IAASB's new standards are not effective until the end of 2016, auditors will need to hit the ground running. There are some daunting changes which will require careful navigation. This will be as new to management and audit committees and users as it is to auditors. Auditors around the world will be on a learning curve – so I ask that stakeholders in the audit give us as much feedback as possible, good or bad, so that we can continue to improve the quality of our reports. It is hugely important that we get this right.

Here at PwC, we are committed to producing informative and insightful reports that reflect the spirit of the reforms. We have listened, we have understood and now we are changing.

Richard Sexton

Richard Sexton

Vice Chairman, Global Assurance

The key changes

The changes that the IAASB is introducing to auditor's reports centre around three key aims: insight, transparency and improved readability.

Insight

Without doubt, the most significant innovation in the new standards is the introduction of 'key audit matters' (ISA 701) – it's the section of the new UK reports that shareholders have inevitably pointed to as being the most valuable. This new section of the report will shed light on those matters that, in the auditor's judgement, were of the most significance in the audit of the financial statements of the current period.

The intent is to introduce into auditor's reports a bespoke description of key areas of focus in the audit – in a sense, a window into what kept the auditor up at night. This won't supplant the auditor's opinion on the financial statements as a whole, which investors value, but it expands the report by asking auditors to describe what the significant issues were, why they were significant, and how they addressed them.

"This innovation in auditor reporting is radical, a step-change as some have called it. It makes the auditor's work more transparent and relevant to users. It stimulates public debate and analysis on what auditors' reports are most helpful."

Arnold Schilder,
Chairman,
IAASB

Transparency

The main proposals to enhance transparency are to introduce an explicit statement regarding the auditor's independence in all audit reports and to identify the engagement partner's name in audit reports for listed entities. Both are already part of the auditor's report in many parts of the world – but it is not the practice everywhere.

Readability

Under the new standards, the auditor's report has been restructured to put audit and entity-specific information at the beginning of the report – in particular, putting the audit opinion first. Standardised wording in the report – such as the descriptions of the auditor's responsibilities and what's involved in an audit – can be placed at the end of the report, or some might even decide to put it in an appendix or refer to a common website (such as that of a standard-setter or regulator).

Going concern will also be given more visibility in the auditor's report. Both management's and auditor's responsibilities regarding going concern will be described in the new reports. When there is a material uncertainty about the entity's ability to continue as a going concern, this will now be highlighted in a separate, clearly identified section of the report. Even when the auditor concludes that there is not a material uncertainty, one or more matters arising from the auditor's work in arriving at that conclusion could be considered key audit matters. A revision to the going concern standard (ISA 570) also reminds auditors to evaluate whether the financial statements provide adequate disclosures when events or conditions have been identified that may cast significant doubt whether the organisation has the ability to continue as a going concern, even if the auditor concludes that no material uncertainty exists.

When?

The new standards will come into effect for audit reports for financial statements relevant for periods ending on or after 15 December 2016, but early application will be permitted. For an update on similar developments around the world, please see Appendix 3, page 15.

Key audit matters – in detail

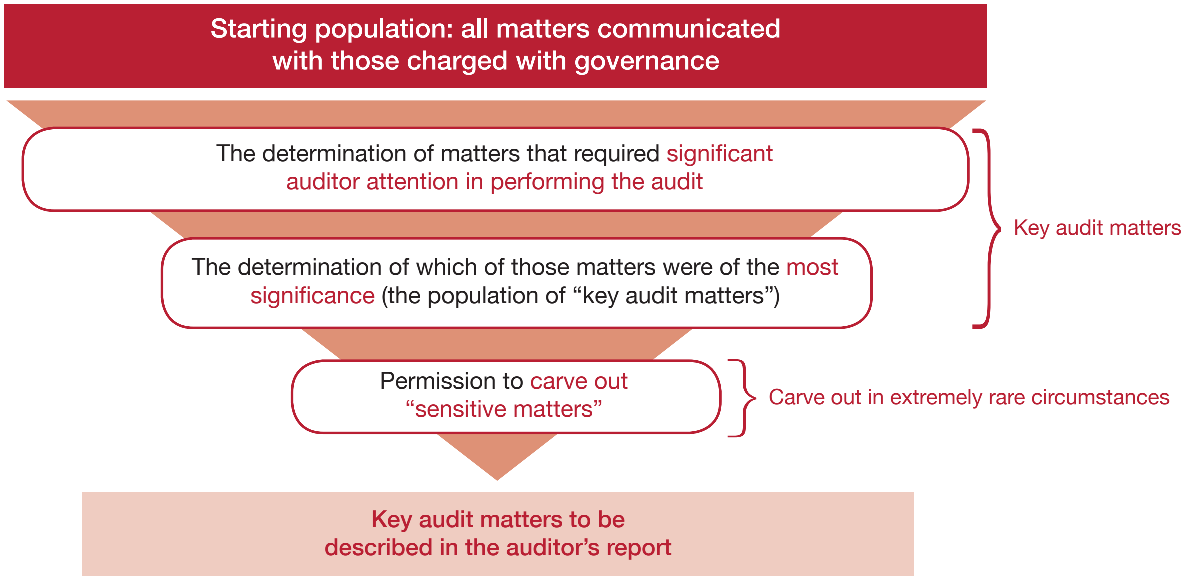
> *"A good report is one where you can cover the name of the company and still be able to tell what industry the company is in and maybe even which company it is"*
>
> *UK investment professional*

How do auditors select key audit matters?

The new ISA 701 observes that professional judgement will be needed to determine which, and how many, key audit matters to include in the audit report. This will be an important judgement. While key audit matters will be drawn from matters discussed with the audit committee, it is not expected that all matters communicated to those charged with governance would be considered key audit matters to be included in the auditor's report. Neither is the ISA looking for a long list, as that would be contrary to the notion of such matters being those of most significance in the audit.

Key audit matters are selected from those matters involving significant auditor attention in the audit. The concept of significant auditor attention, the ISA says, "recognizes that an audit is risk-based", and areas of significant auditor attention "often relate to areas of complexity and significant management judgement in the financial statements". These are, therefore, the areas that, "often involve difficult or complex auditor judgements".

Figure 1. Selecting key audit matters



In practice, this means that the selection of key audit matters is a multi-step judgement. The auditor is expected to take into account:

- Significant risks and areas of higher risk of material misstatement
- Areas requiring significant auditor and management judgement, including accounting estimates identified as having high estimation uncertainty and more subjective areas of the financial statements
- The effect on the audit of significant events or transactions that occurred during that year.

There are some situations in which the auditor would not be required to disclose a matter, such as if law or regulation precludes it, or, in extremely rare circumstances, where the adverse consequences of public communication of a matter would reasonably be expected to outweigh the public interest benefits. The IAASB has been very clear that the provisions should not be abused to avoid disclosing matters that do not firmly fit these circumstances.

By way of implementation advice, the IAASB set out in ISA 701 some considerations that may be relevant to determining whether a matter is significant, and therefore may qualify as a key audit matter.

For an overview of content in the new IAASB reporting model, turn to Appendix 1, page 13.

Describing key audit matters

> *"Investors do not want a list of procedures. They want to know what the key risks are, why they are key risks, how the auditor responded to them and what the auditor found."*
>
> *UK investment professional*

The new ISA requires the auditor to: describe each key audit matter; include a reference to related financial statement disclosures, (if any); and address why the matter was considered to be one of most significance in the audit and how it was addressed in the audit. While the amount of detail is a matter of professional judgement, the ISA notes that this might include:

- Aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk.
- A brief overview of procedures performed.
- An indication of the outcome of the auditor's procedures.
- Key observations with respect to the matter.

How far should auditors go in describing findings?

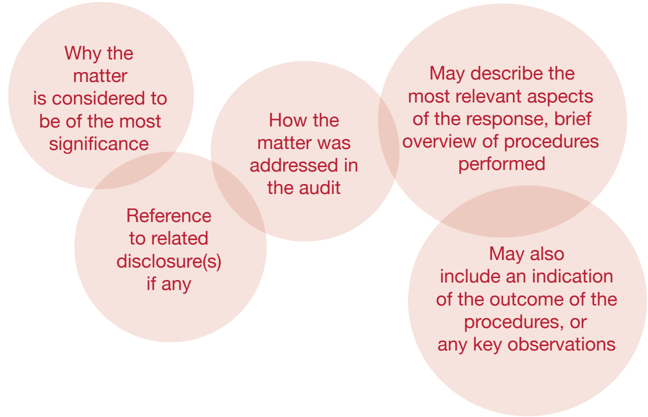
Most of the UK reports in year 1 identified the risk, explained why it was important and described how the audit addressed it. While shareholders have welcomed that insight, many said that they found the descriptions incomplete without the auditor going further to describe the findings or outcome. There are questions around how this can be done meaningfully. For example, might the auditor's view (which will inevitably be subjective to a certain degree) end up supplanting management or directors' judgement – and should it?
Or whether there is a need for some sort of 'safe harbour' that recognises that these are informed professional views, but inevitably the views of an individual. This will no doubt continue to be an area for discussion as experience with the new reports evolves.

A learning curve – variation expected

As auditors implement the new style reports, there will be an element of experimentation. It's almost certain that the resulting reports will vary in wording, tone and depth, at least in the beginning. Clearly, there is a balance to be struck: auditor's reports need to respond to the spirit of the standards, with a user focus in mind. And auditors should be brave in confronting the cultural norms of boilerplate and overwhelming caution.

But forcing the pace of change might have adverse consequences – especially in litigious environments – and this could result in a retreat back to boilerplate. Patience may be needed as the auditing world grapples with how to achieve informative and appropriately focused reports. Already, we have come a long way.

Figure 2. What descriptions of key audit matters will include



Illustrations of key audit matters in UK audit reports

Goodwill and intangible asset impairment assessments, particularly in the Smiths Detection and Smiths Interconnect Divisions

Area of focus

Refer also to note 12 (pages 153-154).

The Group holds significant amounts of goodwill, acquired intangibles and development costs on the balance sheet, as detailed in note 11 to the financial statements. The risk is that these balances are overstated.

We focused on the estimated values in use of the Smiths Interconnect Power cash generating unit, which has a net book value of goodwill of £114.0m, and the Smiths Detection division, which has a net book value of goodwill of £368.6m, given their financial performance in the year. Smiths Interconnect Power's value in use exceeds its carrying value by £7.8m and Smiths Detection's value in use exceeds its carrying value by £165m.

How the scope of our audit addressed the area of focus

We evaluated the directors' future cash flow forecasts, and the process by which they were drawn up, including testing the underlying calculations and comparing them to the latest Board approved divisional budgets. We challenged:

- the directors' key assumptions for long term growth rates in the forecasts by comparing them to historical results, economic and industry forecasts; and
- the discount rate by assessing the cost of capital for the Group

For the Smiths Interconnect Power cash generating unit and Smiths Detection division, we evaluated the reasonableness of the Directors' forecast performance by performing a sensitivity analysis around the key drivers of the cash flow forecasts, in particular:

- the current order book;
- the proportion of recent tenders which have been successful; and
- independent projections of the expected growth of key markets.

We also reviewed the director's assessment of the fair value less costs of disposal.

Having ascertained the extent of change in the assumptions that either individually or collectively would be required for the goodwill to be impaired, we considered the likelihood of such a movement in those key assumptions and the disclosures on sensitivity analyses set out in note 12.

Figure 3. Extract from PwC's audit report to shareholders of Smiths Group PLC

Goodwill impairment assessment

Refer to page 73 (Audit Committee Report), page 111 (Critical accounting estimates and judgements), and pages 124-126 (notes).

We focused on this area due to the size of the goodwill balance (£1,433.0 million as at 30 September 2014), and because the directors' assessment of the 'value in use' of the group's Cash Generating Units ("CGUs") involves judgements about the future results of the business and the discount rates applied to future cash flow forecasts.

In particular, we focused our audit effort on goodwill recognised in relation to the Brazil CGU due to the impairment charge of £44.3 million recognised in the current year. The remaining goodwill balance related to Brazil is approximately £76.8 million. The Brazilian business was acquired by the group in 2012, but performance since acquisition has been impacted by a general deterioration in the macroeconomic environment in Brazil, resulting in the current year impairment.

The most significant element of the goodwill balance is that recognised on the two US CGUs, SBS and SPS, totalling £687.7m. Although, based on historical performance, the Directors believe there is significant headroom between the value in use of the CGUs and their carrying value, this remained an area of focus for us as a result of the size of the related goodwill balance.

We evaluated and challenged the composition of management's future cash flow forecasts, and the process by which they were drawn up. In particular, we focused on whether they had identified all the relevant CGUs, including Brazil and the US. We found that management had followed their clearly documented process for drawing up the future cash flow forecasts, which was subject to timely oversight and challenge by the Directors and which was consistent with the Board approved budgets.

We compared the current year actual results with the FY14 figures included in the prior year forecast to consider whether any forecasts included assumptions that, with hindsight, had been optimistic. Actual performance in Brazil was found to be lower than what had been expected and therefore management has reflected actual FY14 revenue growth rates and operating margins in this year's model. We feel this judgement is appropriate given the past performance of Brazil.

For all CGUs, and in particular, Brazil and the US we also challenged management's assumptions in the forecasts for:

- long term growth rates, by comparing them to economic and industry forecasts; and
- the discount rate, by assessing the cost of capital for the company and comparable organisations, as well as considering territory specific factors.

We found the assumptions to be consistent and in line with our expectations.

We challenged management on the adequacy of their sensitivity calculations over all their identified CGUs. We determined that the calculations were most sensitive to assumptions for revenue growth rates and discount rates. For all CGUs other than Brazil we calculated the degree to which these assumptions would need to move before an impairment conclusion was triggered. We discussed the likelihood of such a movement with management and agreed with their conclusion that it was unlikely.

In respect of Brazil we found the assumptions for revenue growth (11% per annum), operating margin (26%) and discount rate (17%) to be acceptable although note that any change in these assumptions would have a direct impact on the impairment charge.

Figure 4. Extract from PwCs audit report to shareholders of The Sage Group PLC

Reactions

Because the IAASB's standards are only now going live, to understand their potential impact, we have to look at responses to other reforms that closely resemble the new ISAs.

Positive reaction to tailored UK reports

Reactions to the similarly enhanced auditor's reports in the UK have been very positive. In fact, many have said that the first year reports exceeded their expectations. As one UK investment professional said, "I think they are not only a major step forwards, but actually pretty useful and interesting".

Importantly, the UK experience reflects the fact that the UK audit profession embraced the new reports with enthusiasm. Audit firms issued bespoke reports that provided insight into the key issues addressed in the audit. There was motivation to do so, against a backdrop of an engaged shareholder community, companion changes to audit committee reporting and a competition enquiry that promoted greater innovation.

That's not to say that shareholders do not believe there is room for improvement – shareholders clearly see some reports being better than others. But it has been a very good start.

"One benefit of the new reports is the clear demonstration that earnings numbers are subject to many assumptions and estimates and that radically different numbers could be permissible. That is not news to auditors, but it may not be well understood by many investors."

Floyd Norris,
International New York Times

Common views heard on the new UK reports

- The new reports are now more interesting and informative.
- The most valuable section in the new reports is the areas of focus (IAASB's key audit matters).
- Shareholders are keen to hear the auditor's perspective on the significant judgements made in the entity's critical accounting policies and estimates.
- Shareholders are interested in which risks were key in the audit and why, and how the audit responded to them – but they also want to hear what the auditor found.
- The best descriptions are tailored to the particular audit and entity – 'boilerplate' wording and generic descriptions are not helpful.

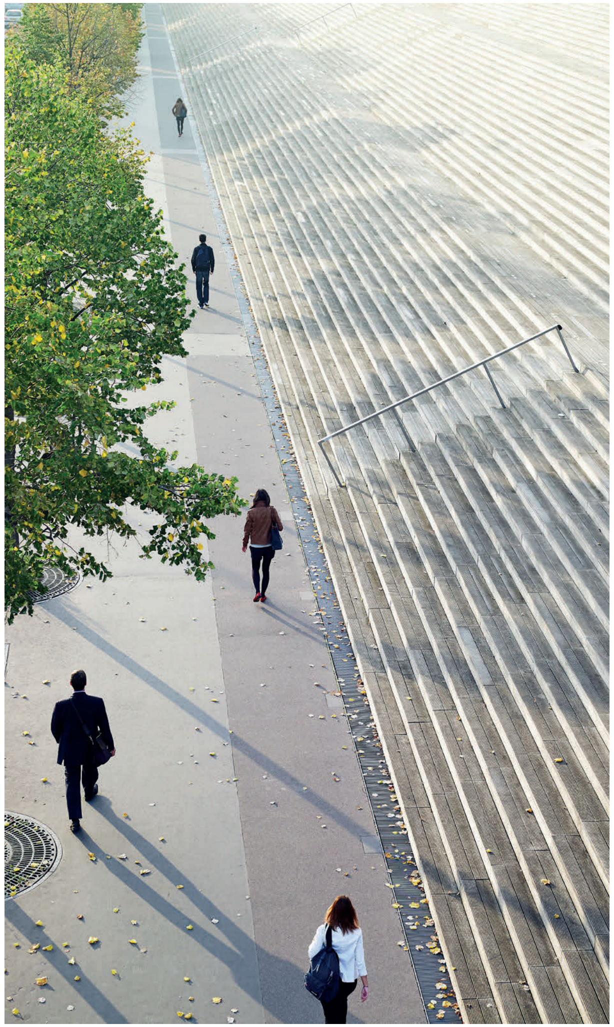
"If this just becomes a boilerplate exercise then it would be a setback, rather than a step forward. For the standard to really be successful, the challenge is to make sure that the key audit matters are tailored to the company and provide useful insight to the various stakeholder groups – and auditors should primarily be thinking about investors".

Bruce Winter,
IAASB Member

In some ways, then, it might be tempting to believe that the UK has set the bar for how the reforms might be implemented elsewhere. But the same drivers for change do not exist everywhere; legal and regulatory provisions influence what and how auditors need to report, and markets and culture vary in different jurisdictions around the world. For example in the UK, the enhanced auditor's reports were implemented at the same time as expanded audit committee reporting requirements. Under the Financial Reporting Council's changes to the Corporate Governance Code, audit committees are expected to describe significant issues in the financial statements that they addressed. These complementary reporting requirements provided a shared agenda for auditors and audit committees that may explain in part why the first year experience in the UK proved to be as successful as it was.

For years, auditors have been required to have standardised reports. Bespoke audit reports are, in a way, counter-cultural. While there will inevitably be similarities between auditor's reports for the same company over a number of years, some fear a risk that the new audit reports could evolve quickly to the use of quite standardised wording to describe similar risks and responses across audit reports. If both companies and the profession do not see the benefits of the new reporting model, and approach the new reports as a necessary compliance exercise only, there is a very real risk of longer reports with simply more boilerplate language. If that is the case, the new reports will fall well short of the aim.

Lessons learned so far



Some of the lessons we have learned so far include:

- **Begin with the end in mind:** The auditor's report may be the culmination of the audit, but auditors need to be thinking about the auditor reporting process from the very outset of the audit. A good audit starts with good risk analysis and scoping, and that's the starting point for reporting too.
- **Anticipate the time involved:** The reports will need to go through multiple iterations and review – that needs to be factored into the audit planning. Keep in mind that discussions on the audit report may lead management to decide to enhance or change their disclosures too.
- **It is the auditor's report, but management and audit committees are keenly interested:** The selection of key audit matters begins with the matters discussed with the audit committee. That is an important starting point. Audit committees are also engaging early and, in most audits, we have found that discussions on what the audit report might look like and the matters it might discuss start very early in the audit process, with a number of conversations taking place before the reports are finalised.
- **Getting the key audit matters right is a very challenging task:** Most auditors intuitively know which matters are the most significant and would be of interest to stakeholders. They will differ from entity to entity. But then it is important to be able to describe them clearly, being precise about what the particular area of focus is, clearly articulating why the audit focused on it and how the audit addressed it. It is not as easy as it sounds.
- **Write with the audience in mind:** The challenge is to draft succinct key audit matters that address the technical aspects, in language that is understandable to all stakeholders, whose backgrounds and levels of expertise in financial matters vary considerably. We have found that this is an iterative process that needs to be critically reviewed from outside the audit team, including the engagement quality control reviewer and the central audit technical team.

It's time to get to work – we're ready

The positive reactions from shareholders and other stakeholders to the new style auditor's reports issued in the UK and piloted in the Netherlands provides comfort that the reports are heading in the right direction. They are being read with interest, and the bespoke narrative and transparency is, according to feedback, giving the kind of insight from the audit that users were seeking.

Implementation efforts now need to pick up momentum around the world. We have had a network of senior partners across our network engaged in the developments from the outset. We experimented early with the art of the possible and carried out field tests and pilots. We are going into the second year of implementation of the similar UK reforms and first year in the Netherlands. This is the most fundamental change in auditor reporting in decades, and though there will be challenges, we have been preparing for what's to come.

Certainly, we are continuing to listen carefully to what all stakeholders in the audit are saying and in each case, we are reflecting on how best to achieve the aim of embracing the new model. We will all be on a learning curve. Realistically, this will not be a one, or even a two-year process.

But the time for debate about the shape of the reforms is over. Instead, it is now time to get to work producing the new reports, sharing our knowledge and experiences and providing the insight that investors and others demand. We look forward to what is to come.

Figure 5. Overview of auditor reporting timeline

Appendices

Contents:

Appendix 1: Overview of content of the new IAASB reporting model

Opinion	The audit opinion and identification of what's been audited will now be the first section of the report.
Basis for Opinion	The Basis for Opinion will directly follow the Opinion section and, in addition to referring to compliance with the ISAs and referring to the auditor's responsibilities section, will now include the new assertion of the auditor's independence. If the audit opinion has been modified, the explanation would be here too.
Material uncertainty regarding going concern (if any)	If there is a material uncertainty with respect to going concern, it will now be described in a separate section that identifies it as such.
Emphasis paragraphs* (if any)	*An emphasis of matter paragraph may be next if, for example, it is relevant to understanding the financial reporting framework, or it might follow the key audit matters if it relates to a matter also addressed in that section.
Key audit matters	The new section providing insight into the key matters addressed in the audit will be required for audits of listed companies, but can also be included voluntarily by others.
Other matter paragraphs* (if any)	*The placement of an Other Matter paragraph could be here if it relates to the financial statement audit only, or later in the report if it relates to other legal or regulatory requirements, or both.
Other information	A new section in the auditor's report will describe the auditor's responsibilities for "other information" (e.g., the rest of the annual report, including the management report) and the outcome of fulfilling those responsibilities.
Responsibilities for the financial statements	The description of management's responsibilities will be expanded to explain its responsibilities with respect to going concern. It will also now identify those charged with governance (if different from management).
Auditor's responsibilities	The description of the auditor's responsibilities under the ISAs is now much more comprehensive and includes a description of the auditor's responsibilities with respect to going concern.
Date, address and signature	In addition to the signature, address and date, auditor's reports for listed companies will now also have to identify the engagement partner's name.

Appendix 2: How the reporting models compare

	IAASB	US PCAOB	UK FRC	EU audit regulation
Stage of development	December 2014 standard	August 2013 proposed standard	June 2013 standard in effect	Final approved requirements
Auditor's report element (for listed company audits,)				
Prominent placement of the auditor's opinion and other entity-specific information	√		√	
Key audit matters/critical audit matters/audit risks:				
• Identification of the matters/risks	√	√	√	√
• Description of how the audit responded to those matters/risks	√		√	√
• Description of the outcomes/findings	*Guidance suggests they may be included*		*Not required but has been included in a few reports*	*Required where relevant*
Key audit input judgments, including materiality and group scoping			√	
Conclusions regarding going concern	*Enhanced descriptions of responsibilities*	*No change to extant model*	*Not required but have been included by some firms*	*No change to extant model*
Statement regarding the outcome of auditor's consideration of 'other information' (e.g., the front half of the annual report)	√	√	√	√
Statement regarding the auditor's independence	√	√	*Reference to the requirement to be independent*	√
Disclosure of the year the auditor began consecutively serving as the company's auditor		√	*Not in the auditor's report but included in the report by the audit committee on its work*	√
Identification of the engagement partner's name	*For listed companies*	*Being addressed in a separate project*	√	√

Appendix 3: Developments around the world

United Kingdom

The UK is heading into year two of its new reporting regime – which shares many features of the IAASB standards, as well as some further requirements such as materiality and group scoping. Second year reports already issued show continuing innovation by auditors in response to feedback on the first year results. For example:

- Greater insight being provided into the rationale for materiality judgements
- Expanded descriptions of the scoping and approach to group audits
- Descriptions of risks and responses becoming more bespoke and specific, with some evidence of further experimentation with how observations and outcomes might meaningfully be provided in the descriptions.

Netherlands

As anticipated, the new style auditor's reports will be introduced in the Netherlands for December 2014 year-end audits. These are required for audits of public interest entities, but auditors of other organisations are allowed to adopt it too. The Netherlands standards use the IAASB's ISAs as a blueprint but also pick up some of the additional requirements from the new EU audit regulation – for example disclosing the date of appointment and total uninterrupted engagement. In a nod to the UK model, the Netherlands report will also require the sections on materiality and the scope of the group audit. Neither is required in the new ISAs or EU Audit Regulation.

US

The Public Company Accounting Oversight Board has signalled its intent to re-expose their proposed standard in Q1 2015. This may enable them to finalise their final standard so that it could become effective at the same time as the ISAs. The PCAOB has also indicated that they will issue a supplementary request for comment on partner naming and identifying other participants in the audit in the near term, which is expected to include an option for these disclosures on a new form filed on the PCAOB's website instead of in the audit report.

Other countries and regions

While there is evidence of heightened awareness in the marketplace, we haven't yet seen other significant regulatory developments. It is likely that national standard-setters who adopt the ISAs into national standards will begin that process now that the ISAs are finalised. One of the main areas of discussion is whether to limit the new reports to listed companies or extend the scope to audit reports for all public interest entities and government entities.

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