An overview of the fundamental changes being proposed to auditor’s reports around the world
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Whether and how the auditor’s report should change has been the subject of much debate since the financial crisis.

There is plenty of evidence that investors value the auditor’s opinion on the financial statements. They don't want to lose it. But in the wake of the financial crises, investors and other stakeholders began to call for auditor’s reports to be more informative. Auditors have unique and relevant insight based on their audits and investors and other stakeholders are asking auditors to share some of that insight.

Earlier this year, the UK Financial Reporting Council (UK FRC) issued its new audit reporting standard. As of October 2013, UK auditors will be issuing the new style more informative reports for certain listed companies.

Whilst the new reports may be a few years off for the rest of the world, what those reports will look like is becoming increasingly clear.

In July and August, the IAASB issued an Exposure Draft and the PCAOB issued Proposed Auditing Standards (for simplicity also referred to as consultations in this paper), which describe their respective proposed new auditor reporting models. New requirements for auditor’s reports in the Europe Union (EU) are an integral part of the proposed Audit Directive and Regulation, which are well advanced through the legislative process.

This booklet provides an overview of all of these developments.

“Both the PCAOB and IAASB exposure drafts have some bold and challenging suggestions – such as providing insight into key or critical matters that the audit focussed on. We now need to consider how these can be practically achieved. We are beyond a debate about the merits of change to the shape of the auditor’s report. Energies need to shift to begin working on what will be needed to deliver the new style reports.”

Richard Sexton
PwC’s Global Assurance Leader
What is being proposed?

In many respects, there is remarkable consistency between the proposals by the various regulators and standard setters, but some notable differences as well – see the table below.

Importantly, fairly broad consensus has emerged that the audit report should not become an original source of information about the entity – that would blur the respective responsibilities of management and auditors. There is also an acceptance that auditors should not be asked to provide views that, in effect, would constitute investment analysis. But between those two extremes, the standard setters see an opportunity to make audit reports more informative and relevant by providing more information about the audit and key areas of focus in it.

### The various proposals at a glance

**Report element**

<table>
<thead>
<tr>
<th>Description of key audit matters / critical audit matters / audit risks</th>
<th>IAASB</th>
<th>US PCAOB</th>
<th>UK FRC</th>
<th>Recent proposals in the EU debate</th>
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<tr>
<td>Prominent placement of the auditor’s opinion and other entity-specific information</td>
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<tr>
<td>Description of key audit matters / critical audit matters / audit risks</td>
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<td>Key audit input judgments, including materiality and group scoping</td>
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<tr>
<td>Conclusions regarding going concern</td>
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<td>Not required but may be included by some UK auditors</td>
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<td>Statement regarding the outcome of auditor’s consideration of ‘other information’ (e.g., the front half of the annual report)</td>
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<td>Statement regarding the auditor’s independence</td>
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<td>Disclosure of the year the auditor began consecutively serving as the company’s auditor</td>
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<td>Included in the report on the audit committee’s work</td>
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<tr>
<td>Identification of the engagement partner’s name</td>
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<td>Being addressed in a separate project</td>
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The new audit reports envisaged by the IAASB, the PCAOB, the UK FRC and the European Commission (EC) all expand the audit report to provide greater insight into the audit. They move away from a report with standard wording to one that is tailored and specific to the particular audit and entity.

Each of the standard setters has described the ‘filter’ to select the key/critical audit matters to be reported differently. The UK model is driven by the audit planning and scoping decisions; the IAASB and PCAOB filters are arguably based more on the outcome of the audit process. The EU proposals are evolving, with increasing alignment towards the IAASB’s ISA requirements.

It will be important during the consultation period to test the ‘filters’ to see whether one or the other is easier to work with, and to compare this to the judgments auditors make in the new UK audit reports issued this quarter. Despite different words being used, it is hard to envisage that substantially different judgments will, or least should, be made.

What auditors say about the matters could be different in the UK because there will be disclosures regarding the significant issues considered by the audit committee in relation to the financial statements in the published audit committee report. However, again, it seems unlikely that UK audit reports will end up being substantively different if they focus on how the auditor addressed the issues in the audit.

**How the proposals compare**

“PwC strongly supports any enhancements to the auditor’s report that will address the needs of today’s users.”

Vin Colman
US Assurance Leader

“Testing these changes in reality is the only way to explore the benefits and expose unintended consequences well in advance of changes in the standard.”

Peter van Dongen
Australia Assurance Leader
Looking more closely at the IAASB and PCAOB consultations

Key proposals in the IAASB’s July 2013 and the PCAOB’s August 2013 consultations include the following (which apply to both unless noted):

- **Key audit matters / Critical audit matters**: Increased transparency into those matters that were of most significance in the audit / involved the most difficulty by including tailored, engagement specific descriptions of the ‘Key Audit Matters’ (IAASB) or ‘Critical Audit Matters’ (PCAOB). Various iterations of a similar requirement have been considered in the EU legislative process and it is hoped that the final requirement will ultimately align with the final IAASB requirements.

  The filter for selecting which matters to report and for the content of the descriptions to be included, whilst similar between the two exposure drafts, are described differently in each and will be an important focus for respondents. The requirements would apply to audits of listed companies only, although the IAASB suggests that auditors of non-listed companies could include this section voluntarily.

- **Going concern (IAASB only)**: A new section in the audit report that makes explicit the auditor’s conclusions – that are implicit under ISA 570 today – on the appropriateness of management’s use of the going concern basis of accounting and on material uncertainties. The introduction of conclusions by the auditor on going concern has been a key element of the EU auditor reporting reforms and that, in turn, has been an important influence on the IAASB’s deliberations.

- **Other information**: A description of the auditor’s responsibilities in the financial statement audit with respect to ‘other information’ in the annual report and the auditor’s conclusion regarding the outcome of those responsibilities. Both IAASB and PCAOB are proposing revisions to the auditor’s responsibilities for that information as part of the financial statement audit.

Recent changes to the EU Accounting Directive have already introduced new requirements for auditors in the EU, which will be brought into the Audit Directive as well. The auditor’s responsibilities for UK auditors were also revised as part of the Effective Company Stewardship proposals.

The cost/benefit and practicability of the proposed work effort was a significant issue in many of the responses to the IAASB’s 2012

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1 The PCAOB’s proposals are an integral part of their auditor reporting Exposure Draft. The IAASB is currently analysing responses to its November 2012 Exposure Draft.
Exposure Draft, which proposed fundamental revisions to the auditor’s responsibilities for ‘other information’. Many thought the IAASB’s proposals were impracticable and likely to exacerbate expectation gaps around the nature and extent of the auditor’s association with the other information. We anticipate that many respondents will be looking closely at the PCAOB’s recent proposals, and the IAASB’s revised proposals when issued, from this perspective.

- **Independence:** An explicit statement regarding the auditor’s independence and the sources of the independence requirements.
- **Enhancements to existing standard language:** Proposed enhancements to the descriptions of an audit and the auditor’s responsibilities (some minimal changes in the PCAOB proposals and more extensive changes proposed by the IAASB).
- **Disclosure of tenure (PCAOB only):** Disclosure of the year that the auditor began serving consecutively as the company’s auditor.
- **Identification of the engagement partner’s name (IAASB only):** Whilst already required in the EU and many other parts of the world, it is not practice everywhere. The IAASB proposes to introduce this transparency for listed companies with a ‘harm’s way exemption’. This matter is subject to a separate project in the US and is not therefore addressed in the PCAOB Exposure Draft.
The UK FRC’s revised auditing standard, ISA 700 (UK & Ireland) was released in June 2013. They were designed to enhance transparency by better communicating to investors about the work that auditors have done and to complement the reporting by Directors and the audit committee introduced in the FRC’s Effective Company Stewardship model in October 2012. As a result, the new requirements apply only to auditor’s reports of those entities that are required, or voluntarily choose, to report on the application of the UK Corporate Governance Code.

The new requirements for both the Effective Company Stewardship and new auditor reporting requirements become effective for audits of financial statements for periods commencing on or after 1 October 2012 (so essentially, beginning with 30 September year ends). Close alignment is anticipated between the risks identified in the auditor’s report and the description of significant issues relating to the financial statements by the audit committee in the section of the annual report outlining their work in discharging their responsibilities – it would be surprising if there wasn’t. Similarly, disclosures relating to risks of material misstatement will most likely also refer to the relevant note in the financial statements that addresses the matter.

Further changes affecting the auditor’s report arising from the implementation of the Sharman Inquiry recommendations regarding going concern are still to come.

New UK auditor’s report

The provision of a fuller description of the work the auditor has undertaken will give far more insight to investors than the current audit report. The improved report will be a better basis for engagement by investors with companies, and we encourage auditors and companies to work together to develop succinct communication to do so.”

Nick Land
Chairman
UK FRC Audit and Assurance Council

“The changes to the external audit report, implemented earlier this year in the FRC’s ISA 700, support a move towards greater understanding of the audit process. We hope that investors will take the opportunity to engage with the audit agenda, asking questions of auditors at AGMs and challenging audit scoping.”

James Chalmers
UK Head of Assurance

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“...”
### Overview of key aspects of the UK reporting model

#### Auditor's Report
- The auditor's opinion on the financial statements
- An overview of the scope of the audit, showing how this addressed the risk and materiality considerations
- A description of the risks that had the greatest effect on:
  - The overall audit strategy
  - The allocation of resources in the audit
  - Directing the resources in the audit
- An explanation of how the concept of materiality was applied in planning and performing the audit.
- Report by exception:
  - If the directors' statement (see below) is inconsistent with the knowledge acquired by the auditor in the course of performing the audit.
  - If the section describing the work of the audit committee does not appropriately address matters communicated by the auditor to the audit committee.
  - If, when reading the annual report, the auditor has identified information that is materially inconsistent with the audited financial statements or is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in performing the audit or that is otherwise misleading.

#### Directors' Report
- Statement regarding whether they consider the annual report and accounts taken as a whole is fair, balanced and understandable, and provides the information necessary for shareholders to assess the entity’s performance, business model and strategy.

#### Audit Committee Report
- A description of the work of the audit committee in discharging its responsibilities, including the significant issues in relation to the financial statements and how the committee addressed them.
The proposals for the new audit regime proposed by the European Commission (EC) that were originally released in 2011 included detailed requirements for the audit report. Although supporting adopting international standards, the EU has always retained the right to specify the content of the auditor report for European statutory audits and will want to specify the minimum content in the Directive and Regulation – with the Directive setting out the minimum content of audit reports for all statutory audits, and the Regulation specifying additional requirements for audit reports for the audits of public interest entities.

The original requirements proposed by the EC for the audit report were detailed and lengthy – considerably more detailed and extensive than the UK, IAASB or PCAOB proposals. They included a conclusion on going concern (which EC officials indicated was, in their view, the most important part of their proposed changes) and various requirements providing transparency into not only financial reporting judgments, but also audit judgments—including significant risks identified and specific information on the audit approach.

The proposals are now working their way through the EU legislative process.

Earlier this year, the JURI Committee of the European Parliament proposed amendments that would align the EC’s original proposals much more closely to the ISA auditor reporting requirements. Many of the controversial detailed provisions regarding the audit approach were moved to the report to the audit committee, where the dialogue between the auditor and audit committee can provide necessary context. The Council of Ministers (the Council) is in the process of agreeing its negotiating mandate vis-à-vis the Parliament.

Once agreed, the Parliament, the Council and the European Commission will start their negotiations with a view to reaching agreement on a joint ‘compromise text’ that will form the basis of any new legislation.

The process will take at least until the end of the year and may take longer than that. It is still too early to tell where the requirements will land. Once approved, Member States will be given time to adopt the Directive into national legislation. The Regulation, which will apply to the audit of public interest entities only, is expected to enter into force two years after publication and will apply directly without transposition into national law.

Status of the developments in the EU
Timing of the various proposals

- **UK FRC's revised ISA 700 (UK & Ireland) released**: 4 June 2013
- **New UK audit reporting standard will be used for audit reports issued after 1 October**
- **PCAOB Roundtable planned in 2014**
- **IAASB Exposure Draft released 25 July**
- **PCAOB Exposure Draft released 13 August**
- **Response to the IAASB Exposure Draft due 22 November**
- **Response to the PCAOB Exposure Draft due 11 December**
- **Final ISAs planned to be released Q4 2014**
- **PCAOB hinting at the possibility of reproposal being needed before the new standard is finalised**
- **Uncertainty remains over the timing of approval of the new EU Audit Directive and Regulation; 2014 is the earliest, followed by Member State implementation**
- **Proposed effective date for both the IAASB and PCAOB is the December 2016 reporting period (i.e., reports issued in 2017)**

Next steps

The debates on auditor reporting are no longer around the merits of changing the model, but are now focussed on the shape of what auditor’s reports will become.

Making changes as significant as those being proposed is not without its challenges. It is, however, time to have the courage and confidence to embrace change. And we do.

It will be important during the consultation period for us to focus on how the desired changes can be practically achieved. That means taking the conversations beyond the backroom and testing the proposals in practice – testing whether auditors in the field can work with the proposed standards to make the judgments that will be needed; and engaging management, audit committees and investors to get their reactions to what the new reports they will be getting will look like.

This sort of 'live' field-testing is really important at this point. The standard setters need robust evidence of the practical implications of what they are proposing, and it is in everyone's best interests to explore the benefits and expose any unintended consequences. The insights gained will help ensure that the final standards are a workable framework and achieve the aim of more informative auditor’s reports.

At the same time, we are also already starting to shift our energies to begin working on what will be needed to deliver the new style reports across our network. Embracing and leading change.
Who to contact

For further information please enquire of your usual PwC contact or the Auditor Reporting Project team:

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