KPMG

cutting through complexity

Enhancing Auditor Reporting

Providing insight and transparency

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PROVIDING INSIGHT AND TRANSPARENCY

The new international auditor reporting requirements will soon be a reality – it's time to get ready

For some time, investors have demanded more than a binary pass/fail opinion from the auditor's report. They want greater transparency about the auditor's responsibilities, as well as insight into what the auditor considered to be the key areas of the audit and what they did in those areas.

I have always felt that we, as auditors, had more insight that we could share with investors. Now, with the advent of new international auditor reporting requirements, we have the opportunity to do just that.

While the overall objectives of transparency and insight will be the same worldwide, the specific requirements may differ by jurisdiction. The effective date for those following International Standards on Auditing (ISAs) is December 2016 year ends. We generally expect many jurisdictions, including the EU, to have requirements in place for December 2017 year ends. Others, for example the UK, have already transitioned and the response has been very positive.

Of course, this is new ground for us all; finding the right balance will be an iterative process, with all stakeholders playing an important role in shaping the future of auditor reporting. As we have gained a lot of experience from the change in the UK, we thought it would be helpful to share the knowledge and experience of KPMG member firm professionals with you, as investors, audit committee members and management.

In this publication we therefore discuss how you may be affected by the changes, we share our experience of some of the factors that will be critical to achieving a successful implementation and we list some steps that you can take now to prepare for the change. We hope that you find it a helpful starting point in understanding and preparing for the new-style audit reports.

Bill O'Mara
Global Head of Audit
KPMG International

AN INTERNATIONAL CHANGE

The requirements will take different forms across the globe, but the goals are consistent

WHAT IS THE CHANGE?

Auditors will be required to describe in the audit reports of listed entities the key areas they focused on in the audit and what audit work they performed in those areas. They will also be required to provide more transparency regarding the auditor's and management's responsibilities with respect to the audited financial statements.

WHO IS AFFECTED BY THE CHANGE?

Auditors may have the primary responsibility for implementing the requirements, but the changes are relevant to and may affect other stakeholders as well, in particular investors and audit committee members.

If you are an investor, you will have access to information that was previously not available. You might consider how to incorporate this information, both in your evaluation of individual companies and when comparing companies. You may also want to consider how the new information can be used to evaluate audit quality both within and across jurisdictions. The new-style audit reports may also provide information on which to engage with management and audit committees.

If you are an audit committee member, you are likely to find that you interact with the auditor more, in particular in discussing the expanded auditor's report prior to release. You might also use this as an opportunity to consider whether disclosures in the financial statements or elsewhere in the annual report and/or in other investor communications need refreshing, otherwise the auditor might be disclosing more information about an item than the company. Engaging in early and open communication with the auditor will help in this regard.

EFFECTIVE DATE

For audits undertaken and reported on in accordance with ISAs, the new requirements take effect for annual periods ending on or after 15 December 2016, although auditors can choose to apply the new standards earlier.

A jurisdiction may set an effective date that is earlier or later than the international effective date. Therefore, it is important to understand how the new requirements will be introduced in jurisdictions relevant to you.

“For the first time ever, audit reports are actually worth reading, because they say something different and interesting.”

Paul Boyle, Chief Audit Officer at Aviva

“Ultimately, all of these reforms are about enhancing audit quality.”

Vincent Papa, Director of Financial Reporting Policy at CFA institute

MANY DIFFERENT FORMS

In many jurisdictions, the local laws and regulations governing completion of and reporting on financial statement audits are based on the ISAs. Therefore, we expect that those jurisdictions that currently model their requirements on the ISAs will incorporate the new requirements into their local requirements. Exactly how the requirements are incorporated may differ, and it will therefore be important to understand the process in those jurisdictions relevant to you.

Some jurisdictions have expanded auditor reporting requirements that are independent of the ISAs, such as the UK (introduced in 2013) and the EU. While the UK and EU requirements are similar to the ISAs, they also include some additional requirements.

Additional EU requirements[1] include	Additional UK requirements include
• Where relevant, key observations related to the key areas.[2] • An opinion on whether the management report is prepared in accordance with relevant legal requirements. • Additional transparency statements, including information on audit tenure, independence and non-audit services. • Additional report to the audit committee. Note: Key audit matter descriptions will be mandatory for all public-interest entities.[3]	• An explanation of the concept of materiality in planning and performing the audit. • An overview of the scope of the audit and how materiality influenced that scope. • Exception reporting by the auditor on the new section of the annual report in which the audit committee describes the significant issues discussed in relation to financial statements and how they were addressed.

A small number of auditors in the UK went further than the requirements to describe findings in their reports that were related to the risks identified. See the audit report for Rolls-Royce Holdings plc.

Future developments

In the US, the Public Company Accounting Oversight Board published proposals in 2013, which included a requirement for the auditor to discuss the areas they judged as being critical to the audit. Revised proposals are expected in Q4 2015.

> **“it is in the public interest for an auditor to provide greater transparency about the audit that was performed. Increasing the communicative value of the auditor’s report is critical to the perceived value of the financial statement audit.”**
>
> Arnold Schilder, Chairman of the International Auditing and Assurance Standards Board

1. The EU legislation comes into effect for financial years starting after 17 June 2016.
2. Under the international requirements, an auditor may choose whether to include key observations.
3. Under the international requirements, key audit matter descriptions will be mandatory for listed entities only.

HOW WE DELIVER INSIGHT AND TRANSPARENCY

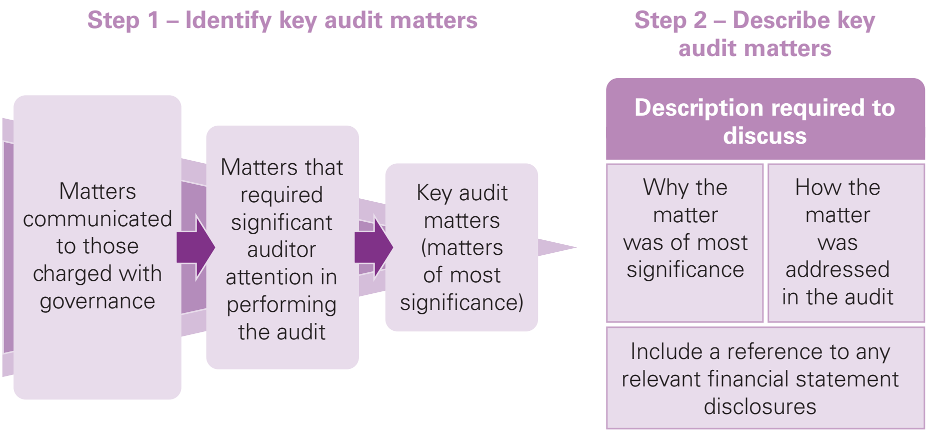
The aim is to relay to shareholders the essence of the conversation about audit risks and approach that is already taking place with audit committees

NEW-STYLE AUDIT REPORTS

Without changing the scope of an independent audit, the new ISA requirements open the door for the auditor to give users more insight into the audit and improve transparency. The most significant change introduced by the new requirements is the requirement for the auditor to include descriptions of key audit matters in the audit report. The other changes introduced as part of the new requirements are highlighted in the illustrative report in the next section of this publication.

KEY AUDIT MATTERS – IN A NUTSHELL

This requirement is designed to give the auditor the platform to highlight the matters they worried about most and focused on during the audit, and how they addressed these matters.



Key audit matter descriptions are written by the auditor based on their judgement, so the way in which similar key audit matters are described may vary from auditor to auditor. A key audit matter description would generally meet the objectives of the requirements if it includes the following features.

- Fact based
- Tailored to the company
- Concise and free from technical jargon
- Sufficient detail to understand how the matter was addressed.

Boilerplate text would obviously not meet the requirements.

> **"We had to think really hard about how to condense the information, while getting the nuances absolutely spot-on."**
>
> Jimmy Daboo, Audit Partner at KPMG in the UK

> **"Truly demonstrating to the reader how we applied scepticism, what experts we used and how, what kind of techniques we used to carry out the audit and the robustness of our audit was difficult."**
>
> Jimmy Daboo, Audit Partner at KPMG in the UK

RESPONSE FROM USERS AND THE REGULATOR

In the UK, feedback from both users and the regulator on the expanded auditor's reports has been extremely positive. The regulator noted in its survey of 2013 new-style auditors' reports that they were very encouraged by the results, which reflected the fact that auditors have embraced the change and been innovative when complying with the requirements.

Investors also value the insight provided by the new-style audit reports. This was reflected in the fact that in November 2014 The Investment Association in the UK (formerly the IMA) hosted its inaugural auditor reporting awards at which KPMG in the UK received awards for 'Most Insightful Auditor's Report' and a number of commendations.

Appendix 1 includes examples of descriptions of risks included in audit reports prepared in accordance with the UK requirements.

> **"The success of the new audit standard [UK] is of paramount importance to the investment industry. Our awards are held in recognition of this, alongside commending greater transparency and excellence in auditor reporting and supporting the industry's progress."**
>
> Daniel Godfrey, Chief Executive Officer at The Investment Association (formerly the IMA)

KEY ELEMENTS FOR SUCCESSFUL IMPLEMENTATION

Buy-in from all key stakeholders was critical to the successful implementation in the UK, with:

- the regulator supporting and encouraging auditors to be innovative in meeting the requirements; and
- investors and audit committee members being engaged and supportive of the process.

This illustrates that if there is a shared sense of direction, a positive view of the changes and a willingness to advance, then expanded auditor reporting can benefit all stakeholders.

Investors see value in reports that…	Critical factors for auditors to achieve successful implementation include…
• are innovative and engaging; • include descriptions that are company-specific; • provide investors with 'hooks' on which to engage further with the audit committee; and • include sufficient granularity to allow readers to understand the risks and how they were addressed.	• starting early in the audit process; • having early and open communication with the audit committee and also management; • being specific about the areas of audit focus and what they did during the audit to address those matters; and • putting themselves in the shoes of the shareholders when considering how to meet the requirements.

> **"We wanted to show the shareholders that we understood what was driving the risks, and how we brought our experience, independence and scepticism to bear on their behalf. That was the mindset that we had."**
>
> Mike Metcalf, Technical Partner at KPMG in the UK

FIRST LOOK AT THE NEW AUDIT REPORT

The new-style audit report is intended to improve transparency

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion[1]

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

1 Required to state the opinion first in the auditor's report, unless a different order is specified by local laws or regulation.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code.[2] We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

2 Required to state independence and specify the jurisdiction.

Key Audit Matters[3]

3 Description of key audit matters (mandatory for listed entities only).

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Name of key audit matter]	
Refer to Note [X] to the financial statements.	
The key audit matter	**How the matter was addressed in our audit**
[describe matter and why it was considered to be one of most significance in the audit]	[describe how the matter was addressed in the audit]

[repeat for each key audit matter]

Other Information[4]

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

4 New section setting out the auditor's and management's responsibilities for Other Information and a statement as to the auditor's findings from the work performed.

Responsibilities of Management and Those Charged with Governance for the Financial Statements[5]

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

5 Revised description of management's and those charged with governance's responsibilities including a description of responsibilities for going concern.

INDEPENDENT AUDITOR'S REPORT (CONTINUED)

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements[6]

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards.

The engagement partner on the audit resulting in this independent auditor's report is [name].[7]

[Signature as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

6 Revised description of the auditor's responsibilities, including description of responsibilities for going concern.

Note that this description could be included in an appendix to the report or on a website in certain circumstances.

7 Required to disclose the audit partner's name (required for listed entities only).

HOW YOU CAN PREPARE FOR THE CHANGE

Discussions and planning for the new-style audit reports can start now

AUDIT COMMITTEES AND MANAGEMENT

Audit committees and management can start preparing now for the new-style audit reports. The graphic below sets outs some of the actions that audit committees and management can take before the first expanded auditor's report is issued on their financial statements.

> **"The differentiation of audit reports is something to be welcomed. And it will be interesting to see where the debate goes."**
>
> Robin Freestone, Chief Financial Officer at Pearson and former Chairman of the 100 Group

INVESTORS

As the broad requirements are now set, investors can start planning how to use the information in the new-style audit reports. If you are an investor, you could start by:

- understanding what information will be available in the expanded auditor's report;
- familiarising yourself with expanded auditor reporting by reviewing reports issued in the UK (see Appendix 1);
- signalling to auditors your expectations regarding auditors' reports prepared under the new requirements;
- identifying how the information may be used to evaluate and compare companies; and
- determining how the information may be used to engage with audit committees.

At a macro level, investors need to continue to engage with regulators and auditors and provide feedback on what could be done to further enhance the information that they are receiving.

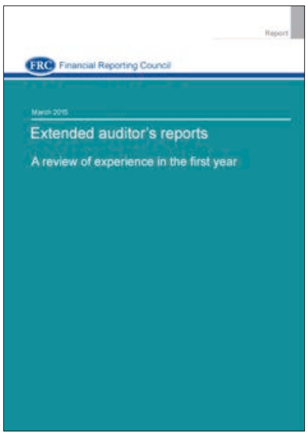
FIND OUT MORE

KPMG in the UK's restoring trust web page

Provides more information on how KPMG in the UK went about restoring trust through enhanced auditor reporting

IAASB's auditor reporting page

Provides tools and resources to help understand and implement the new requirements



FRC survey on extended auditor's reports

Review by the UK regulator of the first year of implementation of the new requirements in the UK

CONTACT US

For more information, please speak to your usual KPMG contact.

APPENDIX 1 – EXAMPLE DESCRIPTIONS FROM UK AUDIT REPORTS

The following examples were extracted from auditors' reports prepared in accordance with the UK's expanded auditor reporting requirements and are provided for illustrative purposes only

Example description

Extract from KPMG LLP, report to Stobart Group Limited shareholders for year ended 28 February 2015

Impairment of goodwill (£59.0m), intangible assets (£57.2m) and property plant and equipment ('PPE') (£221.9m)

Refer to page 57 (Audit Committee Report), page 91 (Accounting Policy) and pages 104 and 108 (Financial Disclosures).

The risk

In prior years the Group has expanded its activities through both the acquisition of businesses and investment in PPE. As a result, the Group's net assets include a significant amount of goodwill, intangible assets and PPE, including £153.1m in relation to London Southend Airport (LSA). Certain of the new businesses, including LSA, are at an early stage in their trading lifecycle, and, as such, there is a risk that they may not trade in line with initial expectations and forecasts, resulting in the carrying amount of goodwill, intangible assets and PPE exceeding their recoverable amount and therefore requiring impairment. In addition, at the year end the Group's market capitalisation was below the net asset value attributable to shareholders.

The recoverable amount for each cash generating unit (CGU) has been calculated based on value-in-use. These recoverable amounts use discounted future cash flow forecasts in which the Directors make judgments over certain key inputs, for example revenue growth, discount rate, long-term growth rate and inflation rates. Overall, due to the high level of judgement involved, and the significant carrying amounts involved, this is one of the key judgemental areas that our audit is concentrated on.

Our response

Our audit procedures included detailed evaluation of the Group's budgeting procedures (upon which forecasts are based) and testing of the principles and integrity of the Group's discounted future cash flow models. We tested the accuracy of the calculation derived from each forecast model and we assessed key inputs in the calculations such as revenue growth, discount rate and working capital assumptions, by reference to the Board approved divisional forecast models, data external to the Group and our own views. We utilised our own valuation specialists when considering the appropriateness of the discount rate and the long term growth rate. We reviewed the historical accuracy of forecasts by comparing the actual results for the year with the original forecasts.

With respect to Brand names, our critical assessment used our own valuation specialists to challenge the assumptions applied in respect of estimates of future cashflows and appropriate royalty and discount rates, and assessment, where applicable, of the appropriateness of the assumption of an indefinite life.

We considered the adequacy of the Group's disclosures in respect of impairment testing, and whether disclosures in relation to the sensitivity of the outcome of the impairment assessment to changes in key assumptions properly reflected the risks inherent in the valuations.

Example description

Extract from KPMG LLP, report to ITV plc shareholders for the year ended 31 December 2014

Royalty accruals (£70 million, see note 3.15)

The risk

The Group pays royalties directly to artists / producers for all content used. The contractual terms of these agreements are varied and complex.

The related IT systems can only address part of the processing, necessitating a significant manual element in calculating royalty accruals recorded by the Group. Overall the process is complex, though core to the Group's operations.

The volume and variety of contracts being interpreted and accounted for combined with the manual nature of the process increases the risk of error.

Our response

Among other procedures, we tested controls over the recording of royalty costs and the approval of royalty payments.

We also reperformed a sample of the Group's annual royalty calculations, agreeing key inputs to contracts and underlying system data.

In addition, we performed analytical procedures comparing royalty costs as a percentage of the related income streams to budgets and prior periods, taking account of any known changes.

Example description Extract from KPMG Audit Plc, report to Greggs plc shareholders for the 53 weeks ended 3 January 2015

Impairment of property, plant and equipment (net charge in year £0.4m, closing net book value £263m)

Refer to page 45 (Audit Committee Report), pages 73 and 75 (Accounting Policy) and pages 84 to 85 (Financial Disclosures).

The risk

- The significant levels of property, plant and equipment held by the Group including assets in over 1,600 shops means that there are many separate cash generating units (i.e. 'shops') that independently expose the Group to a risk that the value of property, plant and equipment balances may not be recoverable in full through either future trade or recoverable value on disposal.
- In addition, following the £4m impairment charge in 2013 and the decision announced in the current year to close the in-store bakeries, countered by a significant improvement in the performance of the Group in 2014, there is also an increased risk of further impairments in some shops whilst previous impairments possibly should be reversed in other shops. This includes the risk that for obsolete assets – e.g. land and buildings which are surplus to requirements, the assumptions over the recoverable amount may have changed over time as intentions change and more information is available.
- Determining the level of impairment and any reversal of impairment involves forecasting and discounting future cash flows and estimation of recoverable amounts which are inherently uncertain.

Our response

Our audit procedures included, amongst others, considering the impairment risk associated with the following different types of asset:

- In respect of the shops which continue to trade we critically assessed and challenged the Group's impairment model. This included consideration of the discounted cash flow forecasts on a shop by shop basis and whether these support the carrying value of the relevant assets as well as if this indicates a reversal of a past impairment is needed. We assessed the cash flow forecasts against the historical performance of those shops and against the Group's budgets. We assessed the appropriateness of the discount rate including benchmarking it against other national retailers. We performed a sensitivity analysis of both discount rates and forecast cash flows and considered the resulting impact on the impairment charge.
- In respect of specific impairments of plant and equipment, we critically assessed the Group's identification of assets that were obsolete and critically assessed whether such assets have any recoverable value or possible further use by the business using our knowledge of the Group and historical experience.
- In respect of owned land and buildings which have been identified as surplus to requirements and which are not being traded from, we considered whether the carrying value of the land and buildings was appropriate with reference to market indicators such as external third party valuations and purchase offers received. This included consideration as to whether assets were impaired or whether previously booked impairments should be reversed.
- We have also considered the adequacy of the Group's disclosures about the degree of estimation involved in determining the amount of impairment and the sensitivity to key assumptions involved.

Example description Extract from KPMG LLP, report to ITV plc shareholders for the year ended 31 December 2014

Defined benefit pension schemes (£346 million, see note 3.7)

The risk

Significant estimates are made in valuing the Group's post-retirement defined benefit schemes.

The key valuation assumptions are set out in note 3.7 in the 'Assumptions' section. When making these assumptions the Group takes independent actuarial advice relating to their appropriateness.

The valuation is considered to be a significant risk as given the quantum of the scheme assets and scheme liabilities, small changes in the assumptions can have a material financial impact on the Group.

Our response

In this area our audit procedures included challenging the key assumptions applied in determining the Group's net deficit, being the discount rate, inflation rate and mortality/life expectancy, with support of our own actuarial specialists. The included a comparison of these key assumptions against externally derived data.

We obtained third party confirmation of the pension scheme assets as at 31 December 2014.

We also considered the adequacy of the Group's disclosures in respect of the sensitivity of the deficits to these assumptions in note 3.7.

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