The audit report journey

kpmg.com/uk

Public statement and invitation

June 2016

Audit reporting is moving rapidly – how far and how fast are important issues that need debate.
Foreword

Audit reporting began a remarkable journey in 2013. That year the long-form report was introduced. Suddenly shareholders were provided with insight about how the auditor had arrived at his opinion. As auditors, suddenly we were communicating with our ultimate client – the company’s shareholders. We were immediate enthusiasts.

Innovation took off. We field-tested reports with more insight about how we arrived at our opinion: graduated findings – how cautious or optimistic estimates were. For 2014 we rolled that out as an open offer to companies, and we saw other firms include binary findings. In 2015 we have included audit planning “risk maps” in some reports, explaining the wider picture of audit risks.

This journey prompts two questions. First, for any individual company, which step or stop along this journey, which we explain here, do you want to reach? At KPMG we do not insist on going beyond what is required by FRC standards, but we suggest that companies actively consider and talk to their shareholders about where they should be – which of our steps you want to reach. Whatever a company decides, we are happy to take our reporting to its shareholders up to that level. We recognise, of course, that not everyone wants or needs to be in the vanguard of change, and we respect companies’ views, and we ask that others do too.

The second question is this: in the near future, for public interest companies, what step will regulation require audit reporting to reach? EU audit reform, taking effect later this year, may require more than the basic long-form report. So there needs to be a debate and consensus about whether and how much further it goes. Two groups have a strong interest in this: the investment community and corporates.

In this public statement we look at each step along the journey and the need to settle the question of how far up the line the UK’s implementation of the EU rules move reporting. Our Restoring Trust and Investor Insights webpages are open to host the debate.

Simon Collins
UK Chairman, Senior Partner

Adrian Stone
Partner, Head of Audit
The basic long-form report – now for AIM companies too

This level of report is currently required for all premium listed companies and any that voluntarily comply with the UK Corporate Governance Code. So it has not been required, for example, for AIM companies. This is set to change. New auditing standards will require it, for years commencing on or after 17 June 2016, for companies on AIM or any other market.

The rationale is to stay in line with new international rules. Equally, however, annual reporting to outside shareholders – stewardship – is not significantly less important for an AIM company than for fully listed. Perhaps it is more important, since AIM shareholders may not be able to engage individually and regularly with their companies in the way that they do for the fully listed.

That stewardship relationship depends on trust, and the audit report – which is for, and addressed to, shareholders – contributes to that by providing assurance over the annual accounts. The long-form report takes matters a stage further by moving beyond a binary assurance opinion and standardised text. It provides shareholders with a window into the audit – an understanding of how that binary opinion was formed and hence more confidence in the audit. It sets out the materiality measure used, the degree to which parts of the group were scoped-in to the audit and, most importantly, specifically what audit issues the auditor faced, their underlying causes and how they were addressed. It tells a company’s shareholders what their auditor did on their behalf, explained in terms highly specific to the audit in question.

This will soon be required, but for any AIM company that wishes to make that step-up early, at KPMG we are ready to deliver that.

The risk There is a risk of irrecoverability of the Group’s goodwill balance due to varying levels of demand in certain markets. An impairment assessment of goodwill is carried out annually by the Group by assessing the value in use of Group’s of cash generating units (CGUs) which requires significant assumptions about future developments. Due to the inherent uncertainty involved in forecasting and discounting future cash flows, which are the basis of the assessment of recoverability, this is one of the key judgemental areas that our audit concentrated on.

Our response In this area our audit procedures included testing the Group’s budgeting procedures and the principles and integrity of the Group’s discounted cash flow model. This included comparison of the key assumptions to external data as well as our own assessments in relation to key inputs such as revenue growth, gross margin assumptions, cost inflation and long-term growth rates based on our knowledge of the industry. We considered the historical accuracy of the Group’s growth assumptions and used external data and our own valuation specialists when assessing the discount rate applied. We compared the Group’s market capitalisation to the valuation derived from the forecasts used in the impairment calculations to assess their reasonableness. We further critically assessed the sensitivities applied by the Group. We also assessed whether the Group’s disclosures about the sensitivity of the outcome of the impairment assessment to changes in key assumptions reflects the risks inherent in the valuation of goodwill.

Other example reports for reference

Merlin Entertainments plc Standard Chartered PLC Charles Stanley Group PLC Co-operative Group Limited
Binary findings

Whilst we have pioneered the reporting of graduated findings (see page 4), we recognise that it is a huge step up, and one that many companies, notwithstanding a strong commitment to good governance, feel naturally hesitant about taking. A smaller, or perhaps intermediate, step is binary findings.

In contrast with a graduated finding that indicates the auditor’s assessment of, say, the degree of caution or optimism within the acceptable range for a key accounting estimate that the audit focused on, a binary finding reports whether it was within or outside the acceptable range. Naturally, this provides less insight into the process by which the auditor formed his opinion. After all, in most cases one might expect that all of the key risk areas would be within the acceptable range if the audit opinion is unqualified. However, that is not necessarily always so. For example, this approach would require the auditor to consider whether to include information on:

- audit differences that have not been adjusted (whether or not they result in a qualified audit opinion);
- audit differences that have been adjusted in the final financial statements; or
- control weaknesses identified in a focus area where the audit approach was mainly controls testing.

So there can be some value in binary findings, and for some they might also represent a step on the way to graduated findings. Accordingly, we are happy to provide this level of reporting for companies that choose it. We ask, of course, that the choice is made before the final audit commences. That way it will be clear for its shareholders that a company’s choice is free of any question of bias based on knowledge of the audit findings.

As a result of our work, we determined that the quantum of impairment recognised in 2015 was appropriate. For those intangible assets, where management determined no impairment was required, we found that these judgements were supported by reasonable assumptions.

KPMG LLP, report to the members of Smith & Nephew plc
Graduated findings

Although take-up has been only eight listed companies, our graduated findings approach continues to receive positive feedback from the investment community. This approach details the result of audit tests in the key risk areas – typically about significant judgments, such as accounting policies, or estimates where there is a range of acceptable outcomes – in more specific terms than acceptable/unacceptable. For example, estimates within a range might go from “optimistic” to “cautious” with a “balanced” mid-point, which is the weighted reporting that we have provided to audit committees for many years. So it provides shareholders with a more nuanced understanding of the audit – of the professional judgments weighed up in arriving at the audit opinion on the accounts as a whole.

We recognise that amongst companies views differ on this. For example, some see this as something that the audit committee would report or perhaps the company itself in the accounts. If so, we respect that. At the same time we believe that better stewardship relationships between companies and their shareholders are in everyone’s long-term interests, and we believe that the highest level of audit reporting helps to put that relationship, in which the annual accounts are a key feature, on a more solid foundation of trust. So we continue to stand ready to provide this form of reporting where, before the final audit commences, the company engages us to do so.

In determining the appropriateness of the rebates, chargebacks and returns deductions in accordance with contractual and regulatory requirements, there is room for judgement and we found that within that, the Group’s judgement was balanced (2014: balanced). We found the assumptions used and the resulting estimates to be balanced (2014: balanced). We also found no errors in the year-end rebate accrual calculations. We found the disclosures on rebates, chargebacks and returns to be proportionate.

KPMG LLP, report to the members of AstraZeneca PLC

We found the resulting estimate of the recoverable amount to be mildly optimistic and the Group’s disclosures with regards to the impairment testing for the HDSA receivable to be proportionate in their description of the assumptions and estimates made by the Group concerning the value of its underlying collateral.

KPMG LLP, report to the members of Lonmin Plc
This year, in a small number of reports, we have introduced insights into our audit planning. We listed not only the risks for which we have explained how they arise and how we have addressed them, but also risks that were not quite significant enough to merit full explanation in the report.

We have presented this in the way that we typically report our audit planning to the audit committee, by putting the risks against a scale of potential impact and a scale of likelihood of material misstatement. The resulting “risk map” enables shareholders to see not only the other key matters that received attention but how close those matters were to being among the most significant risks.

Showing this dynamic planning tool also provides a more immediate way to communicate changes in risk assessment since the previous year.

When taken together with the reporting of graduated findings, we hope that the resulting picture of the audit will provide more understanding for shareholders of what lies behind the binary opinion on the accounts as a whole—an end-to-end picture of the work that we did on their behalf to arrive at that opinion.
How far do the EU rules move reporting?

For years commencing on or after 17 June 2016 the EU audit reforms will require auditors to report the risk, the response and “where relevant, key observations”. This will also be implemented in the FRC’s auditing standards. It will apply only for public interest companies. These are companies with securities admitted to trading on an EU regulated market – e.g., the main market of the London Stock Exchange, and equivalent markets elsewhere in the EU – and unlisted banks and insurers.

For such companies, how far along the journey does this require audit reporting to go? Answering that is also an opportunity to reflect on progress since 2013 and to decide where next. It is beyond any one firm to be able to decide that, and the FRC’s latest draft standards leave the question unanswered. It is more properly a question for affected stakeholders than for auditors. Consensus and codification are required:

— Does “observations” mean graduated findings, binary findings, or something else?
— When might observations be “relevant” – always, or only in specific circumstances?
— What do companies see as being in the best interests of their relationship with their shareholders?
— What will shareholders expect?
— How will the audit regulator regulate this?

This is too important a challenge and opportunity not to be publicly debated. We encourage the investment community and companies to make their views known.

The audit report shall provide, in support of the audit opinion, the following:

I. a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud;
II. a summary of the auditor’s response to those risks; and
III. where relevant, key observations arising with respect to those risks.

EC regulation 537/2014, article 10(2)(c)