Deloitte.

June 2013

Governance in brief
Audit reports to be more informative

Headlines

In parallel with the significant other changes being introduced for September 2013 year ends onwards, auditors of listed companies will now be obliged to provide shareholders with real insight into how their audits are performed by:

- describing the risks that had the greatest effect on their overall audit strategy, the allocation of resources in the audit and the direction the efforts of the engagement team;
- explaining how the concept of materiality was applied in planning and performing the audit; and
- giving an overview of the scope of the audit, showing how this addressed the risks described.

Audit has traditionally been a 'black box' with shareholders only seeing a pass/fail report using standardised language. These changes will help shareholders understand the complexity of the judgements underlying annual financial statements and the challenge of these by the independent auditors: the changes will increase investor confidence in the integrity of financial statements, a major component in effective capital markets.

Background

For a number of years investors, and more recently the Competition Commission, have been calling for the audit process to be more transparent. The FRC's new standard completes their work to make the audit process more transparent which started with the changes made to the UK Corporate Governance Code last autumn. For 30 September year ends onwards, the annual report is required to include the following:

- the critical judgements formed and key estimates made by management in preparing the financial statements;
- the audit committee's report on the significant issues that it considered in relation to the financial statements, and how these issues were addressed; and
- the external auditor's report on the risks they identified which had the greatest effect on their audit and their audit response.

The UK is not alone in moving towards a more discursive audit report – the PCAOB in the USA, the European Commission and the International Auditing and Assurance Standards Board all have initiatives in this area. However, the UK has led in this area, reinforcing London's position not only as a leading capital market but as a centre for leadership in thinking on Corporate Governance matters.

Scope of the requirements

The new requirements will apply for entities which are required, or choose voluntarily, to report on their compliance with the UK Corporate Governance Code. This will include:

- companies with a premium UK listing of equities, who must apply the Code; and
- companies with a standard UK listing and those admitted to trading on other markets such as AIM, ISDX Growth and the new High Growth Segment, together with many building societies, who choose to apply the Code.

The new requirements apply for periods commencing on or after 1 October 2012.

Planning the audit committee's response

What's new in the auditor's report?	What does this mean for the audit committee?
 Auditors must describe the risks of material misstatements that had the greatest effect on: • the overall audit strategy; • the allocation of resources in the audit; and • directing the efforts of the engagement team.	Audit committees will want to review an early draft of the audit report rather than waiting until the audit is almost complete. They will want to: • understand the auditors' risk assessment, including the rationale for choosing which risks will be included in the external auditor's report; • explore any inconsistencies with the issues that they are planning to discuss in their own audit committee report and in the critical judgement section in accounting policies; and • consider how this fits with the description of principal risks and uncertainties in the front half (the "strategic report"), recognising that these are the principal business risks and not necessarily risks that the financial statements are misstated.
 Auditors must explain how they applied the concept of materiality in planning and performing the audit, including stating the materiality used for the audit as a whole.	Audit committees will want to consider their own assessment as to what is material and ask: • When reviewing the external auditors' planning report, do they have any comments on the auditors' planned approach to materiality and significant risks? • Is there a need to revisit the Company's approach to the correction of errors identified by auditors?
 Auditors must give an overview of the scope of the audit, showing how this addressed the risks they described and was influenced by the application of materiality.	This is the first year in which audit committees will have to discuss the significant issues that they considered in relation to the financial statements, and how these issues were addressed, having regard to matters communicated to it by the auditors: • Is there scope to discuss potentially difficult and contentious issues early? • Has the audit committee considered how their report will be drafted? Care must be taken to explain the judgements made, drawing out any key assumptions – avoiding language that might undermine the figures in the financial statements.

Reporting by exception

It is important to remember that auditors will also now be required to report by exception, in the audit report, on two aspects of the 2012 UK Corporate Governance Code – this was announced in the autumn when the revised Code was issued:

- As explained above, the audit committee will need to report the significant issues it considered in relation to the financial statements and how those issues were addressed. The auditor is required to report by exception if the audit committee's report does not appropriately address matters communicated to the audit committee by the auditor.

- In addition, under the 2012 UK Corporate Governance Code, boards will have to state that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy. The auditor is required to report by exception if this board statement is inconsistent with the knowledge acquired by the auditor in the course of performing the audit.

Planning ahead – time to take action

There are a number of other changes that will apply for September 2013 year ends and onwards including:

- application of the 2012 UK Corporate Governance Code and related Guidance on Audit Committees;

- the move to a separate "strategic report" to replace the "business review" in the directors' report, which is required to include material on strategy and business model, diversity and human rights issues;

- the introduction of mandatory carbon reporting for quoted companies;

- revised directors' remuneration reports for quoted companies; and

- the FRC's encouragement to consider the Sharman Principles when drafting going concern disclosures, pending revised guidance for 2014.

These changes, together with the new audit report and changes to IFRS such as IFRS 13 – Fair Value Measurement, will mean that future annual reports will look very different to the past and require significant drafting and design effort.

All of this means that boards will want to consider the timetable of board and committee meetings to assess:

- if the board, audit committee, remuneration committee and, if there is one, risk committee have sufficient time to consider these new and substantial requirements;
- if there is enough time built in for management to pull together the various elements of the annual report and to ensure they form a cohesive whole; and
- to ensure there is the chance to engage seriously with known issues that are capable of earlier resolution to avoid too many moving parts when the full annual report is assembled.

Of course, planning for these substantive changes is a challenge when several of the key rules and regulations have only just been published. Nevertheless, our recommendation is to take action early. Failing to plan ahead could result in an undesirable scramble, with consequential unnecessary risk to the timetable and quality of the next annual report.

An early example of the new audit report

Vodafone has published their annual report and accounts and include a report in the new style – go to **http://www.vodafone.com/content/index/investors/investor_information/annual_report.html** to access the annual report and read the audit report on the consolidated financial statements on pages 88 and 89.

More information
A copy of the revised standard, ISA 700 (UK & Ireland) (Revised) The independent auditor's report on financial statements, can be obtained from the FRC website www.frc.org.uk

The Deloitte Academy
The Deloitte Academy has been designed for main board directors of listed companies. The Deloitte Academy provides support and guidance to boards, individual directors and company secretaries of listed companies through a programme of briefings and update sessions. Bespoke training for the whole board or individual directors is also available.

If you would like further details about the Deloitte Academy, including membership enquiries, please email enquiries@deloitteacademy.co.uk

We value your feedback
If you find our publications useful or would like to see other topics covered please provide your feedback
We also provide tailored discussions for boards, so please let us know if this is of interest.

Tracy Gordon – 020 7007 3812 or trgordon@deloitte.co.uk

William Touche – 020 7007 3352 or wtouche@deloitte.co.uK

UK Centre for Corporate Governance
For further information on corporate governance matters please go to www.corpgov.deloitte.com/site/uk

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 27565A