

The revolution in audit reports

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Executive summary

For a very long time, the evolution of audit reports proceeded at a glacial pace. Back in the 1800s when Samuel Lowell Price and William Cooper established their businesses in London, audit reports were extremely brief, often fewer than 50 words. Today, with the reports only expanding by a few words to a couple of paragraphs. Even so, the reports were still generic and used largely standard language. Today,

however, in the UK at least. Extended audit report requirements have been introduced for certain companies, which, in the sedate world of auditing, was a daring move and not without controversy. Our profession woke up to the fact that our audit reports could be valuable tools delivering insights in their own right.

At PwC, we wholeheartedly support and embrace these advances and believe that the product of our often complex and extensive audits should be more than a brief, binary, “black and white” opinion. The new audit reports give shareholders a new level of understanding of what an audit entails, and how judgements are made - helping to begin to eliminate the expectation gap.

Following the revolution, our challenge now is to keep the momentum going. We will continue to work hard to make our audit reports as innovative, insightful and useful as possible. In this document, we’ve taken a look at our progress in the first couple of years of the new requirements and the feedback we’ve received, in order to see where even more improvements can be made.

If we consider what we have achieved and the advances we have made in a very short period of time, this is a moment of revolutionary change for the profession.



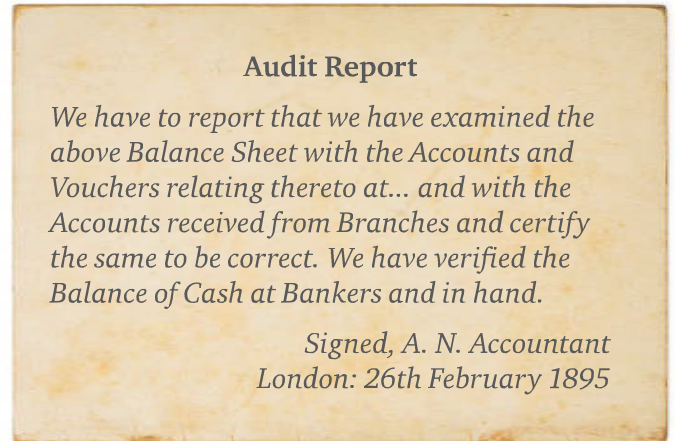
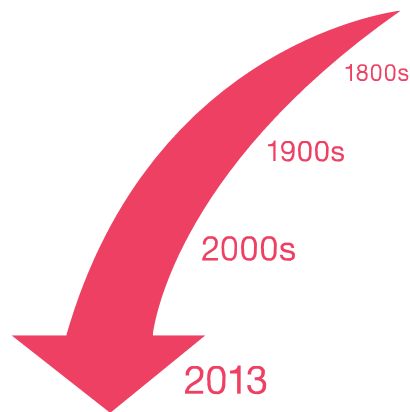
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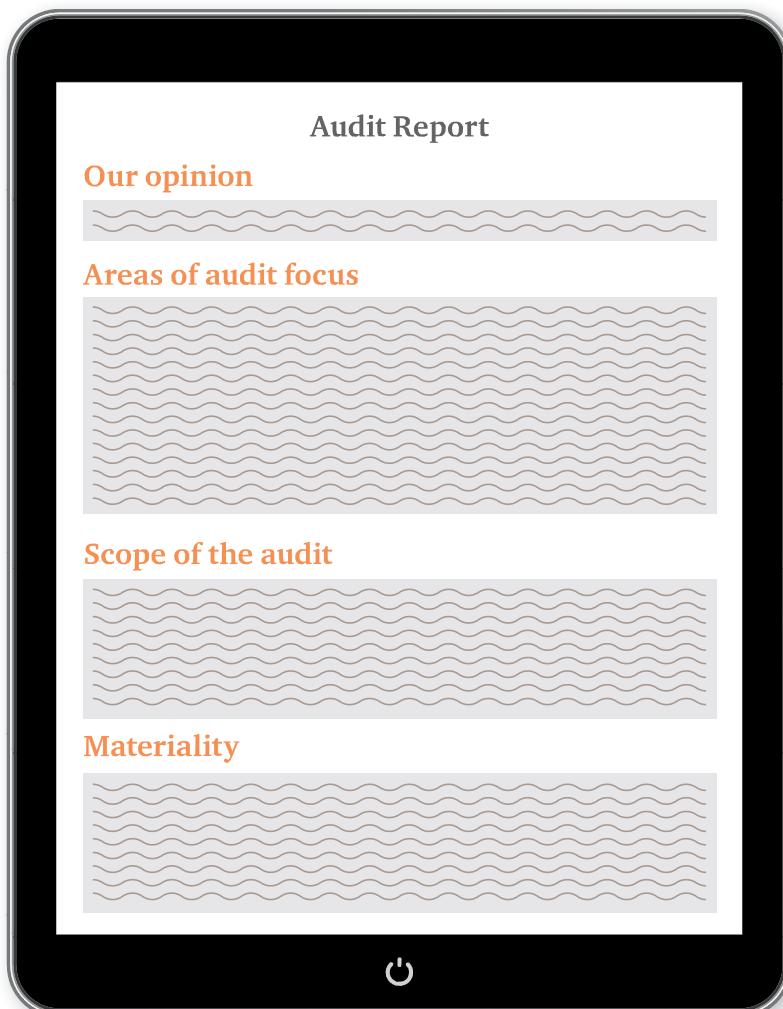
Evolution of audit reports

200 years of UK history shows us a steady profile of industrial evolution, punctuated, of course, by remarkable moments, like the commercialisation of steam power and the creation of the World Wide Web. Over that time, UK audit reports have evolved too.

Audit reports in the 1800s consisted largely of just the opinion and were very brief, often less than 50 words long.



Compare this to today's extended audit reports.



Our opinion is now less than a tenth of the overall report

We now describe the risks of material misstatement that had the greatest effect on our audit and how we addressed those risks

We highlight where we performed our work, and why, both from a geographic and company structure perspective

We describe the materiality we used to help us determine the scope of our audit and to evaluate misstatements

Where we are today

Today's extended audit reports are a significant departure from the boilerplate, "black and white", binary opinion of five years ago. They provide an insight into the audit process, audit quality and provide the auditor's unique perspective on the risks and challenges faced by companies. Feedback from shareholders shows that they no longer "flick past" the audit report, pausing only to look for modifications. In fact, some shareholders have told us that the audit report is the *first* thing they turn to in the Annual Report and that it is a valuable engagement tool which they use to focus their discussions with directors. We've found that the new audit reports not only enhance dialogue between shareholders and directors, but are also providing the key to the audit "black box", explaining much more of what an auditor actually does.

Unlocking the black box increases the level of trust that shareholders place in an audit, and therefore, in the financial statements. By exposing the multiple decisions and judgements taken, it allows the true complexity of the audit to be understood.

Our experience of the extended audit reports

We've always been very supportive of the new requirements. In year one, we took great care as we wrote personal and unique audit reports for the first time. In year two, we gained more confidence, and we introduced some new approaches, many of which go above and beyond the minimum requirements of the standard. Feedback suggests the changes have greatly enhanced the content and value of our audit reports.

The following extracts illustrate the innovations we introduced in year two.



Extracts from the area of focus on 'Impairment assessment – Goodwill and other intangible assets and Russia'

... The French mainstream business, with £162m of goodwill and intangibles, has been loss making and is highly dependent on the **North African destinations**, where there is **continuing political unrest**, and the success of the cost reduction plan. The judgement over the extent of revenue to be generated from North Africa is a key area of focus...

We ensured our reports were as impactful, interesting and company specific as they could be. So much so, that if the name of the company was covered up, the reader would still be able to determine the identity of the company being audited.

We focused on specific events and circumstances, both macro and micro, that impacted the company in the year under audit and made sure that our audit reports fully reflected the significance of these events.

... There has been investment in the **Online Accommodation businesses** for the last three years, with £253m of goodwill and intangibles. Management is forecasting high revenue and profit growth rates in the next five years resulting from **the investment in Brazil and in Asia**. If these growth rates are not achieved, it could lead to impairment of the related goodwill and intangible assets...

...the Group has a joint venture in Russia and Ukraine. Following **the civil war in Ukraine and the impact of the devaluation of the rouble**, the businesses in Russia and Ukraine made losses in the year and there is uncertainty over the future trading environment and cash flows from these businesses...

How our audit addressed the area of focus

... For the France mainstream business, **we focused on the assumptions about the impact of the political unrest on sales in North Africa**, management's ability to retain sales growth by offering alternative structuring of recent years. **Based on the booking pattern of TUI France's customers this year and analysis of the size of the French market for overseas travel we concurred with management's position...**

We decided that all our audit reports should include the results of our audit work, as well as describing the procedures we'd performed. After year one of the new audit reports, shareholders told us they were left thinking "so what?" once they'd read about our response to the audit risks. Talking about the results of our work helped answer this question.

In year two, we focused on the information that the user would find most useful and informative about the company and about our work.

... For the Online Accommodation business **we focused on understanding and challenging management plans for future growth**. We noted that these plans are driven by cost savings from shared IT platforms and back office functions for the key businesses in this cash generating unit (CGU) and considered these were achievable and within management's control. We applied sensitivities to the assumptions on speed and extent of market penetration, particularly in AsiaRooms and MalaPronta, **this analysis showed that although different assumptions could have been made, those chosen by the Directors sat within an acceptable range...**

... We reviewed the likely future cash flows from the Russia joint venture and **focused on the speed at which the Russian market will return to trading levels similar to that achieved in 2013**. The level of trading will determine the ability of the business to generate sufficient cash to repay the trading and non-trading balances. **We agreed with management's conclusion to impair the loans and the October and November 2014 committed funding. We read investment committee and Board minutes and discussed with management and as a result were satisfied there is no unprovided committed funding to the Russia joint venture...**

Setting out the results of our work – the big debate

Audit reports give an opinion on the truth and fairness of the financial statements **as a whole**. They're not designed to give assurance on individual parts of the financial statements. The challenge in presenting the results of our work was to avoid creating the impression of “mini-opinions” against each of our areas of focus. So we decided not to present a “conclusion” or “findings” at the end of each risk and response, but instead incorporated the results of our work into the description of our response to each risk. This also meant that we could answer the “so what?” question without disrupting the flow of the narrative. This approach is certainly more subtle than some of our competitors, but we believe it leads to a greater level of insight. Our audit partners are “telling the whole story of their audit”.

Extract from the Ocado Group plc 2014 audit report

Extracts from the area of focus on 'Commercial income'

...Ocado has three main streams of commercial income;
promotional support; media income; and volume rebates (stated in order of value, highest to lowest).

... The amount to be recognised in the income statement for elements of commercial income requires management to apply judgement based on the contractual terms in place with suppliers and estimates of amounts the group is entitled to where transactions span the financial period-end...

... Promotional support and media income arrangements are typically structured to last for a four week duration and are settled with suppliers within a short period following the relevant service or promotion having been fulfilled. This income stream involves high volume, lower value arrangements and requires limited judgement or estimation by management in determining the amount that the group is entitled to. Notwithstanding the limited judgement involved, the magnitude of this income is highly material. **Our focus was therefore whether an arrangement or agreement for the promotional support and media income recognised existed, whether the relevant promotion or media advertising had taken place and whether the income recognised was recorded in the appropriate period..**

... The third stream of commercial income, namely volume rebates, is the one which, in our view, involves the most judgement. Volume rebates are earned both on supply arrangements managed by Waitrose (as the group's supply partner) under the Waitrose sourcing agreement referred to on page 10 and on arrangements with direct suppliers to Ocado...

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, we identified the specific areas of each risk, breaking down that risk into its component parts, and, where helpful, explained how the parts were accounted for.*

Extract from National Grid plc 2015 audit report

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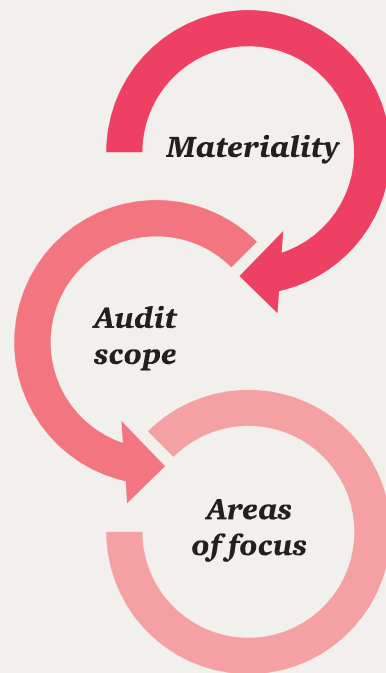
, including how the structure and environment of the company impacted our approach.

National Grid is listed on the London and New York stock exchanges and its principal activities are regulated electricity and gas operations in the UK and northeastern US. In the UK, National Grid's activities are focused on gas and electricity transmission and gas distribution. National Grid's business in the US includes gas and electricity distribution and electricity transmission as well as delivery of gas and electricity to end users across a number of states. National Grid also operates a number of other activities which include Grain LNG, Interconnectors, Metering and UK Property. As a result, key focus areas for National Grid in both the UK and US are network investment and the associated financing, and maximising returns allowable under regulatory frameworks. These activities provide the context for our audit together with, in National Grid US, the ongoing work to improve business processes and financial controls.

Extract from the Centrica PLC 2014 audit report

We changed the structure of our reports to make them more focused and user friendly. In year one we decided to put the opinion at the start of the report. We took this further in year two by adding an "Overview" section near to the front, which provides a snapshot of the audit.

Overview



Materiality

Overall Group materiality: £101 million (2013: £116 million).

Audit scope

- We conducted our audit work across the Group's locations including the UK, the Republic of Ireland, Europe, the US and Canada.
- Senior members of the Group audit team performed site visits across the Group's locations. This included the recent Board Gais Energy acquisition in Dublin and the Hess Energy Marketing division of Direct Energy in New Jersey. Visits were also made to Direct Energy in Houston, the Canadian exploration and production business and the significant parts of the UK business including British Gas and Centrica Energy.
- Taken together, the territories and functions where we performed our audit work accounted for 93% of Group revenues and 82% of Group profit before tax.

Areas of focus

Our areas of audit focus comprised:

- Impairment assessment
- Valuation of derivative transactions in commodity trading
- Presentation of exceptional items and certain re-measurements
- Onerous contracts
- Downstream revenue recognition
- Pensions
- Decommissioning provisions

What do stakeholders think?

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held a number of outreach events with shareholders, audit committees and company management to understand their views.

Shareholders

So, what are the views of shareholders and other external users, such as fund managers, corporate governance experts and analysts, about the extended audit reports, and in particular, the changes we have made in year two? We've set out opposite some of the useful feedback we have received.

“The extended audit reports shine a light on the black box of the audit”



We have seen increasing evidence of shareholders wanting to better understand the audit process and the basis for the many decisions we make in scoping and performing our audits. The extended audit reports go a long way towards educating readers on the many inputs, outputs and complexities in the audit process.

“The new reports are becoming an increasingly important source of information...they fill in the gaps from our review of the financial statements”

“The reports enable us to have a better informed conversation with the audit committee”



Shareholders have a number of sources of information available to them in their review of the financial statements. The extended audit report has become a valuable source that a number of shareholders have come to rely upon to fill in the gaps and provide them with an additional level of confidence in the reported financial information. It has also become a useful engagement tool in their discussions with directors and the audit committee.

“Although the description of materiality has improved since year one, it could be further improved – particularly the description of why a specific benchmark was selected, especially if this differed from the benchmark used by management or had changed as the audit progressed”



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– particularly the way we describe the reason for using a specific benchmark, changes in that benchmark as the audit progressed and any differences in the benchmark from the one used by management.

“Having the results of your work in the audit report highlights the thoroughness of the audit and the openness of management, although, clearer and more consistent language would help”

“High level glossing over of issues reduces our trust in management”



All those we spoke to agreed that having the results of our work included in the audit report was helpful and informative. That said, we still have further to go in terms of using more clear and consistent language and being definitive about whether or not we have a concern.

Where the results of our work described an issue that we had encountered in the audit and how this was discussed with management and resolved, this was viewed positively by the shareholders as it highlighted the thoroughness of the audit and the openness of management, suggesting that a clear, open, well-written and informative auditor’s report can enhance shareholders’ confidence in the quality of the disclosures in the financial report as a whole.

“The description of the audit scope is useful information but it could be presented in a more informative way. For example, putting the information in tables or charts, with accompanying narrative and including a discussion of why you did what you did and where you did it”



We’re increasingly seeing evidence of shareholders wanting to understand audit scoping – via investor briefings held at our clients – and wanting to challenge it, for instance through AGM questions.

Some of the questions raised in our discussions with shareholders highlighted the need for further education about the audit process. Consequently, we’ve developed educational videos targeted at the investment community, explaining in plain language how an audit works in practice (See Auditor View publications within www.pwc.co.uk/audit-assurance/publications/auditor-view-insights.jhtml).

Audit Committee Chairs

Audit Committee Chairs are broadly supportive of the extended audit reports. They feel that the level of detail in our year two reports is good, particularly given these reports are the output of an often very complex and time-intensive audit process. Most Audit Committee Chairs supported the inclusion of the results of our audit work, with one commenting: “It wouldn’t make sense to have this much granularity and not finish the story”. With regard to materiality, the same Audit Committee Chair felt that users were often staggered by the sums involved and suggested that providing context, including the lower thresholds used for components and/or planning would also be helpful.

Management

On the whole, company management has responded very positively to our extended audit reports. Without a doubt, management and directors are now more involved in discussing and understanding the audit process than ever before. Many have expressed a keen interest in the expanded content of our audit reports in order to ensure balance with the rest of the Annual Report. Indeed, some saw it as affirming their own disclosures. One client described the audit report as a validation of their own reporting, providing users with the comfort that the external auditor has considered the judgements taken by the company and concurs with them.

There are still some who believe that the extended audit report is more of a compliance tool and are less convinced that it could be insightful and informative to shareholders. We’ll keep working to change this view!

What's next? Year three and beyond

Our next step is to take the feedback we have received on our year two audit reports and factor this into our audit reports going forward. We'll certainly be focusing on highlighting changes over time (in risks, scoping, materiality, systems, policies etc.) in order to help shareholders understand how "the story of the audit" changes from year to year. We'll also be experimenting with some more exciting ideas on individual reports as we work hard to make our reports even more useful to their users.

The biggest challenge for us and our profession is to continue to work to change the perception of what the audit report is and what it can be. We have some great momentum in this area which we need to maintain by keeping our reports fresh, and not letting today's innovations become tomorrow's boilerplate descriptions.

Internationally, the landscape is also changing and of course we'll be considering the impact of international developments in auditor reporting, with both the EU directive and IAASB's new auditor reporting standard becoming effective.

Stakeholders are concerned and we are excited to see what the next evolution, or revolution, will bring.

Get in touch

Please let us know your views by discussing this document with your normal PwC contact or you can also contact the authors of this publication directly.



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