ICAEW
AUDIT AND ASSURANCE
FACULTY

The start of a conversation

THE EXTENDED AUDIT REPORT

Foreword

This paper will help preparers and users of extended auditor reports in the UK and overseas to implement and understand them.

Globally, we are at the start of the conversation for extended auditor reporting with revised and new auditor reporting ISAs implemented for accounting periods ending after 15 December 2016. Extended auditor reporting was implemented successfully in the UK in 2013. Since 2013, it is interesting to note how far the UK has come: from the short, boilerplate, uninformative report to the extended report covering the Key Audit Matters over a number of pages. However this is a fragile achievement and everyone involved needs to continue to support informative auditor reporting.

All this represents a significant challenge for the profession. There is a real risk of failure, but the prize is worth striving for: clear communication of the value and relevance of auditing.

This publication does not provide all the answers but promotes the self-critical awareness the profession and its stakeholders need to meet the demands of business and society in the 21st century.

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1. Introduction

Warmly welcomed by investors, the extended audit report has revolutionised auditor communications in the UK to such an extent that it can often be a differentiating point in the competitive environment of mandatory audit tendering and auditor rotation in the UK. It has even generated an awards ceremony!

Previously, all audit reports were virtually the same with the only difference being if there was a modification to the report, for example due to a disagreement over accounting treatment or the inability of the auditor to obtain enough audit evidence. Of course, in some circumstances standardisation is useful and provides a benchmark on which to base decisions. However, the feedback on extended audit reports has indicated that homogeneity in audit reports is not helpful. In fact, even in France where a 'justification of assessments' has been required since 2003: studies have found 80% of matters disclosed were cut and pasted from the previous year (Bedard/Gonthier-Besacier 2013) and descriptions of audit work had a 'somewhat disturbing level of homogeneity' (Bedard/Gonthier-Besacier 2014).

We believe that every company and every audit is different and so each audit report should also be different. They should be insightful, dynamic, relevant, interesting and a useful source of information. They should have a positive impact on company and auditor behaviour that promotes transparency, reliability[1] and a willingness to share perspectives. To do this extended audit reports need to avoid boilerplate content as much as possible.

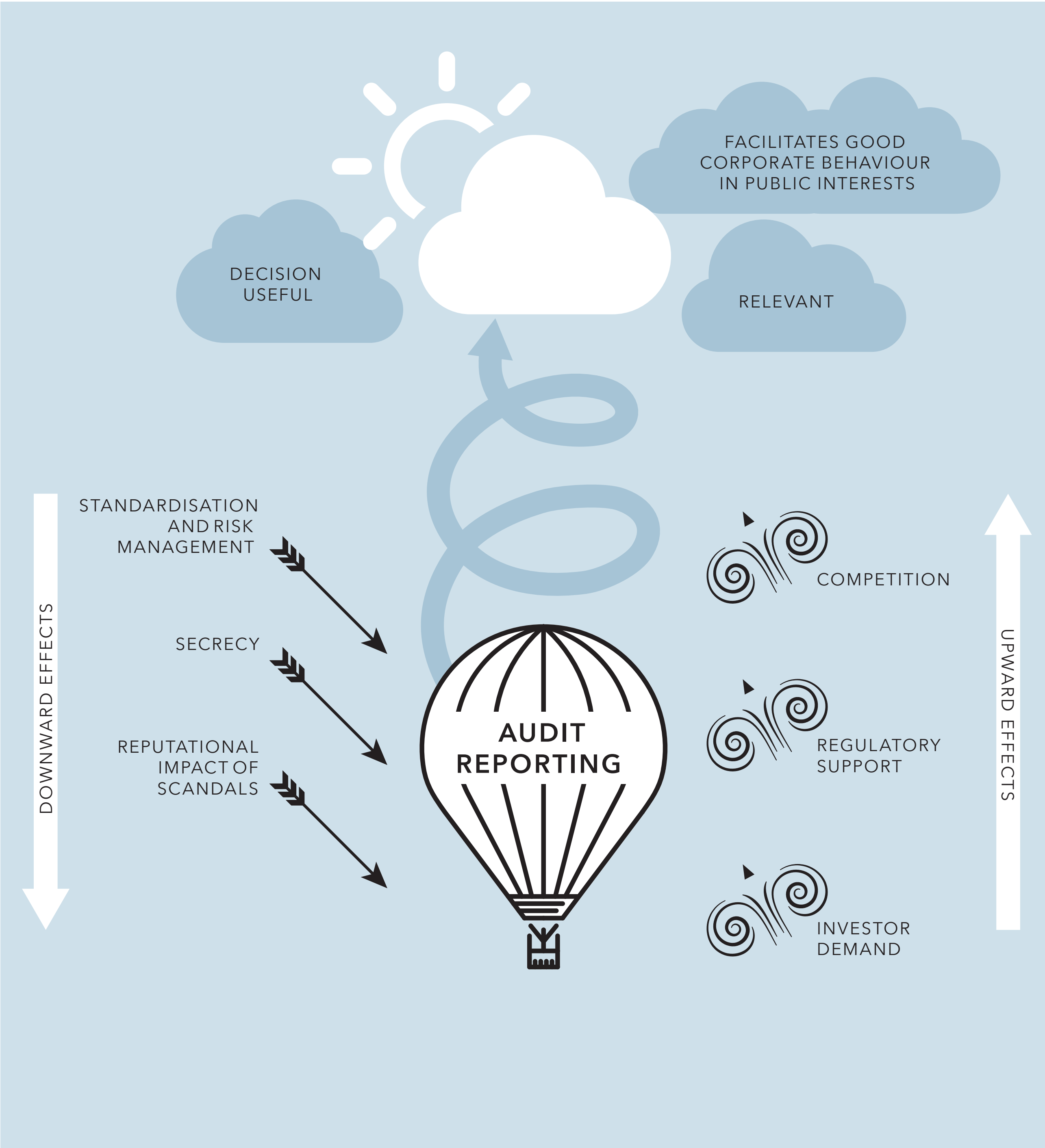
By building on the UK experience to date, this publication sets the blueprint for achieving this goal and is a useful guide for international and UK adopters of the extended audit reports standard.

'We have noted a further welcome move away from generic risk descriptions and language generally in favour of more granular descriptions'

FRC (Extended auditor's reports: a further review of experience 2016)

[1]Reliability matters: reliability and the central role of the auditor (ICAEW 2013)
http://icaew.com/aqfreliabilitymatters

THE EXTENDED AUDIT REPORT: FRAGILE ACHIEVEMENTS



2. The power of the audit report

In the wake of the financial crisis, improving the auditor's report has been a focus for US, global and EU regulators and standard-setters.

The UK mandated a new audit report for 2013 year ends that acted as a pathfinder for some of the IAASB's proposals and added further requirements. The IAASB issued its standards on extended audit reports in 2015. The PCAOB held roundtables on its proposals in 2014 and published its standard in 2017.

There are some similarities between the models of the various regulators and standard setters. All of them envisage a more bespoke and informative auditor's report that will supplement the binary 'pass/fail' audit opinion with greater insight about the audit and key areas of focus in it.

Many see the introduction of Key Audit Matters (IAASB) and Critical Audit Matters (PCAOB) will be the most valuable to users, increasing the information value of the auditor's report. Deciding which matters to highlight and what the auditor should say about them are critical to getting the model right.

Some UK auditors also exceeded the minimum extended audit report requirements, for example by reporting findings and conclusions on the Key Audit Matters (KAMs) reported. Some of these reports have even won prizes and are discussed in more detail in section 3 of this paper.

BRIDGING THE INFORMATION AND EXPECTATIONS GAP

> ***' The auditor's report is the key deliverable communicating the results of the audit process. Investors and other financial statement users have asked for a more informative auditor's report – in particular for auditors to provide more relevant information to users.'***
>
> Quote from IAASB website 30 June 2016 http://www.iaasb.org/new-auditors-report

Audit reports can now not only provide insight into the financial statements and the company under audit, but can also help to bridge the information and expectation gaps when it comes to what an audit actually involves. These gaps still exist under extended audit reporting but attempting to bridge these gaps will improve the relevance, usefulness and confidence in audit and audit quality; and this has been embraced by the audit profession in the UK (see how in section 4).

Auditor reporting is powerful: when the auditor states that the financial statements do not give a true and fair view, the effect on a business can be immense. This is an extreme example, and most audit reports are not in this category, but more colour can promote competition and choice in the audit market and provide greater understanding of the audit to investors, consumers and other stakeholders in a similar way that financial reporting transparency has done for businesses.

BENEFITS AND CHALLENGES

'The Intended Benefits include:

- Enhanced communication between auditors and investors, as well as those charged with corporate governance;
- Increased user confidence in audit reports and financial statements;
- Increased transparency, audit quality, and enhanced information value;
- Increased attention by management and financial statement preparers to disclosures referencing the auditor's report;

- Renewed auditor focus on matters to be reported that could result in an increase in professional skepticism;
- Enhanced financial reporting in the public interest'.

Quote from IAASB website 30 June 2016 http://www.iaasb.org/new-auditors-report

Other benefits include:

> '***Long term benefits include a more open and better understood audit process. Engaging with more people in terms of what an audit is (and isn't) and helping more people access and understand financial information (for example, private shareholders who do not have intermediaries to interpret the financial statements). The reports could also improve audit quality as they put key judgments under much more scrutiny.***'
>
> Quote from PwC – UK Experience of implementation of the enhanced auditor's reports

While we firmly believe audit reports should be insightful, we do acknowledge the concerns expressed by some over potential increased liability and cost, particularly for those entities whose size (among other factors) make cost/benefit considerations more important. There is also a risk of increasing homogeneity over time if the auditor has nothing new to say and the market punishes outliers.

> '***Risks include becoming complacent over time; that the reports become boilerplate such that not only are they not interesting or useful, but they become misleading in their portrayal of the current audit.***'
>
> Quote from PwC – UK Experience of implementation of the enhanced auditor's reports

That said, these concerns are not insurmountable and so we have provided guidance on producing insightful reports in section 4 of this paper.

3. The UK experience

So, as we have discussed above, there is a great deal of appetite and support for making the extended audit reports as insightful as possible. Given they have been issuing extended audit reports since 2013, has the UK achieved this goal?

BACKGROUND IN THE UK

The UK regulator, the FRC, made significant changes to corporate reporting and auditor reporting requirements in 2013 in order to provide users of financial statements with more transparent information. One of the aims was to 'start a conversation' between the users and producers of corporate financial information in order to help underpin confidence in the quality of financial reporting and audit in the UK.

The changes set three high level requirements, for the auditor's report to provide an overview of:

- those risks of material misstatement that were identified by the auditor, and which had the greatest effect on the audit strategy, resources required and the work of the engagement team (broadly equivalent to the IAASB definition of 'Key Audit Matters');
- the application of the concept of materiality; and
- the scope of the audit, including how it responded to the risks of material misstatement and the application of materiality.

The first reports were required for September 2013 year ends.

UK EXPERIENCE OF THE NEW REQUIREMENTS

In order to understand the UK experience to date, it is helpful to explain the key differences between the existing UK requirements and those in ISA 701.

The UK requirements did not originally refer to the term 'Key Audit Matters' and instead asked auditors to describe risks of material misstatement that had the greatest effect on the audit and how the auditor addressed those risks. While there was also a lot less guidance for auditors about how to determine these risks than is included in ISA 701 about how to determine these risks, generally the factors that were considered should be similar.

In addition, the UK requirements went beyond reporting on the key risks and required the auditor to report on two other significant aspects of the audit.

- The first was a requirement to explain how the auditor applied materiality in planning and performing the audit, including explicitly stating the materiality level used. This was included in order to give more context to the key risks that were reported.
- The second area was to provide an overview of the scope of the audit and in particular how the scope selected was responsive to the risks included in the audit report. Auditors typically deal with this requirement by stating the level of coverage of the various geographic and business locations that were subject to audit, by reference to percentage of revenue, total assets or profit that these locations represent. Auditors may also disclose the extent to which they were involved in audits that they did not perform directly, such as where the auditors were performed overseas by another auditor that may or may not be part of the auditor's network of firms.

These additional requirements have been maintained in the UK now that the international standard has been adopted globally.

The institutional base in the UK has supported the new requirements: the London capital market is international and competitive so embraced innovative practice in auditing and reporting. Some companies even adopted the extended auditor report before its implementation date.

Other parts of the world may not have such a supportive environment for extended auditor reporting and the impact of different governance regimes is discussed at the end of this chapter. Companies and auditors may need further support, for example from regulators, to successfully implement and maintain the achievements of these reports around the world.

MANAGING RISKS: THE JURY IS OUT

The media, legal and disciplinary reaction to scandals such as Tesco and Rolls-Royce will impact the development of extended audit reports in the future. These are fragile achievements and the whole system needs support and encouragement to avoid boilerplate and enhance quality.

If scandals occur and auditors go unpunished then the relevance of the audit is questioned. However, if significant reputational damage for auditors results from auditing companies subject to scandal then information value may be lost in catch-all legalese in extended audit reports.

Notwithstanding the scandals that have affected companies in the UK market subject to extended auditor reporting, no noticeable effect has yet been seen on these reports. The risk appears to be, in many respects, similar to that for a short-form report, and indeed, the disclosure of KAMs may help auditors manage their risks in auditing large companies. Time will tell!

UK EXPERIENCE OF HOW TO KEEP REPORTS INSIGHTFUL OVER THE YEARS

For more mature businesses, auditors may not expect much change in their KAMs year on year. However, most companies will experience some changes over time, be it in their structure, environment, products, industry etc. Clearly the directors do not issue identical annual reports every year, so why would the auditor issue an identical audit report? Admittedly, many aspects will be the same, but if we are being truly specific to the events and circumstances of that particular year and making the KAM as granular as possible, we would expect to see changes in the specifics year on year. Another way to keep the report fresh, above and beyond that required by the standards, is to describe the facts and circumstances that have led to a new KAM in the year or changes that have led to the removal of a previous KAM. A context section could also set the scene for the KAM by describing events that have impacted the company in the year (assuming already disclosed by the company) and, by its very nature, will be fresh each year.

Innovation and insight in auditor reporting have become areas of competitive difference in the UK, helped by a more competitive market through mandatory tendering, and subsequent rotation, of auditors of listed companies. Let’s hear directly from engagement leaders on engagements that have demonstrated innovation and leading practice recognised in the Investment Association awards.

ROLLS-ROYCE – THE EP'S PERSPECTIVE

http://www.rolls-royce.com/~/media/Files/R/Rolls-Royce/documents/investors/annual-reports/2015-annual-report-v1.pdf

The Rolls-Royce audit report won the Investment Association award for the disclosure of the risk of material misstatement for its 2014 report. In the 2015 audit report Jimmy Daboo, the KPMG EP also included an audit risk map in the audit report for the first time. Here are his insights:

My client was Rolls-Royce, not the maker of the car – they sold that quite a few years ago to BMW, but the manufacturer of aero engines for use on commercial and military aircraft and of power solutions for use on ships or on land in off highway applications such as for heavy land, rail and defence vehicles, and for the oil and gas industry.

Q&A

What were the benefits of extended auditor reporting in this case?
Rolls-Royce is a complex business with business cycles that can last 15-20 years in the civil aero sector and so its accounting involves some very significant judgements and estimates. Small plausible changes in these can have a material impact on the annual profit so it is important that investors are confident that the company is providing transparent disclosure of the impact of changes in those judgements and estimates on its results and that management is making reasonable judgements.

A standard long form audit report would give them this. However we thought that investors would value more – that they wanted to know how cautious or aggressive the key judgements were. A standard audit report could not provide that and so that's why an audit report that gives the auditor's view on those judgements was so valuable in the eyes of investors. That's not to say they want to supplant management's judgements with KPMG's but it did give them an alternative data point to use in making their own assessments and in their discussions with management.

Additionally we added a full risk map, as derived from our Dynamic Audit planning tool, to our audit report which showed not only how we were seeing the accounting risks evolve over time but also gave insights into the risks that were important but not quite important enough to be discussed in detail in the audit report. This, I think, gave them confidence that we had not missed something that they had expected to see just because it was too far down the 'pecking order' but also opened up other avenues of enquiry for them.

What were the challenges?
There were relatively few. All of the material being disclosed is in the same form as that communicated to the audit committee, which helped. It did take some time making sure that we clearly explained what the risk map represented so as to be sure it would not be misunderstood.

Why did you win the prize?
You will need to ask the judges that! But I think it's because of showing continuing innovation and going beyond the standards trying to anticipate investors' needs. The 2014 award was in the 'risk of misstatement' category.

How did you do it?
Early drafting of the audit report (most of it can be drafted at the audit planning stage), early dialogue with the client, and the necessary involvement of the RI in the drafting process are all important.

Anything you would do better next time?
I think the risk map is an important addition. It will be relatively rare that the 'top' risks that are described in standard extended audit reports change much period to period. But the risk map will show change and evolution.

MARKS AND SPENCER, A FTSE 100 RETAILER OF FOOD AND CLOTHING – THE ENGAGEMENT TEAM'S PERSPECTIVE

The Marks and Spencer audit report won an Investment Association award for the best overall report for a FTSE 100 company for its 31 March 2015 audit report. Here Ian Waller, the Engagement Partner, and his team give their insights on how they won the prize.

Q&A

What were the benefits of extended auditor reporting in this case?
The key benefit was that it forced us to focus more on what the real risks and judgements were as we knew these would be presented publicly. This was a first year audit and so we really wanted to demonstrate both to the entity and to shareholders that we understood the business and the key audit issues. This also meant that we were focused on developing appropriate and clear audit responses to address these risks.

What were the challenges?
The key challenge was striking the right balance between giving more colour in the audit report and potentially disclosing more information than was disclosed by management in the annual report. Also, we needed to let the entity know early on that our audit report would be much longer than in previous years so that when designing their glossy report we were allocated sufficient space!

Why did you win the prize?
The report won for best overall report in the FTSE 100. It won for a variety of reasons:

- the report looked visually insightful – we included a number of charts in the report, such as in relation to materiality and audit scoping;
- we included findings against each of the risks, giving an overview of the results of our audit work in the key areas;
- there was quite a bit of detail in the risk descriptions and responses that were focused on the specific factors facing the entity;
- for materiality, we went beyond the requirements of the UK standard and also disclosed the range of component materialities that we used;
- we also highlighted key aspects in each section – for example at the start of the risk section briefly explaining the key risk areas before going into the detail.

How did you do it?
We spent significant time thinking about how we could best communicate our work to investors both within the audit team and drawing on the input of Deloitte specialists. We also made sure that we drafted the report early so that there was time for all of the relevant stakeholders to get comfortable with the content of the audit report.

How are you going to maintain this standard?
We have already prepared our report for the following year and sought to make further improvements – we have been even more specific in pinpointing the risks, including more visuals (eg, reconciling the adjustments from statutory profit to 'underlying' profit) and tables against some of the risks to make the report more impactful for investors and referenced more relevant disclosures in the financial statements.

Anything you would do better next time?
We are continuously monitoring practice around the detail included within findings as the implementation of the new EU rules requiring auditors to report on 'key observations' draws nearer.

Audit reports on smaller organisations have also won the IA awards, showing how practitioners have been innovative to provide a scalable solution.

FRIMLEY HEALTH NHS FOUNDATION TRUST – THE EPS PERSPECTIVE

The Frimley audit report won the Investment Association award for 'Other entities' in 2015 for the audit report for the year ended 31 March 2015. Clive Everest was the PwC engagement partner. Here are his insights:

Frimley Health NHS Foundation Trust is a healthcare provider serving the population to the West/North-west of London, based at three main hospital sites.

Q&A

What were the benefits of extended auditor reporting in this case?
Foundation Trusts (FTs) provide hospital and related health services, which are at the heart of local communities. Local people feel passionately about their hospitals and their performance, as they have a very real and direct influence on their lives.

The audit report we prepare is addressed to the governors of the FT, who are drawn from across the local population. Many governors do not have a finance, business or accounting background and hence are not familiar with audit reports or auditor responsibilities. Producing an extended audit report provided a means to engage in a new and informative way with governors (and FT management) about the work that we did, the key audit risks and the critical judgements made, making the audit more understandable.

I also believe one of the real benefits of extended reporting is that the auditor has to clearly express their assessment of risks on that audit, and the approach they have taken to address these. The drafting of a good extended report quickly exposes where the audit team is not really clear on the precise concern, or their approach is inappropriate. This should already be apparent on every audit file, but the discipline of setting this out formally in a published report somehow brings this into even sharper focus – that can only be a good thing.

What were the challenges?
It was the first year that FTs had produced extended audit reports. As such there was no precedent to follow, and no clear template of good practice. That is a challenge, but also liberating to some extent. Drafting the audit report was therefore a time consuming process, to strike the right balance between excessive detail and being over-concise. We were also very conscious in this case that we needed to write a report in 'plain English' to make it accessible to the governors, avoiding jargon wherever possible.

Why did you win the IA award?
I believe we won the award for two reasons:

Firstly we were clear from the very beginning on what we saw as the key audit risks. We discussed these fully and openly with FT management and the audit committee at the planning stage, and devised a clear approach to respond to each area. Consequently when we needed to draft the extended report, all of the thinking had been done – we just needed to explain it clearly in the report.

Secondly, we tried to tell the story of this audit through our report: we did not try and be generic or draw on other examples across the firm. To that extent it was tailored, specific and relevant. We also tried to put ourselves in the shoes of those who would use the report, drafting it throughout in a way that we hoped was clearly understandable to people without a financial background.

How did you do it?
Primarily through several things:

- being clear on what we wanted to achieve up front;
- starting the drafting process early, to allow time to review and amend the report. Not producing it in a rush at the end;
- involving a number of the team to contribute to drafting the report, and to reviewing it (both cold readers and team members);
- being candid and open about the audit and its risks, with the full support of the FT management; and
- by not seeking to copy others: we wanted this to be the story of this audit, not generic FT audits.

How are you going to maintain this standard?
Ironically one of the challenges has been not to follow last year's report too closely. It is easy to take a successful report one year and use that as the base for the next. Each audit is different though, so there is a fine balance to strike between consistency and making sure we avoid the extended reports becoming generic across years or organisations. We have therefore used the same framework and style as a base, but then re-drafted the report for the next year almost from scratch, without any centrally provided wording in the key risks sections of the report.

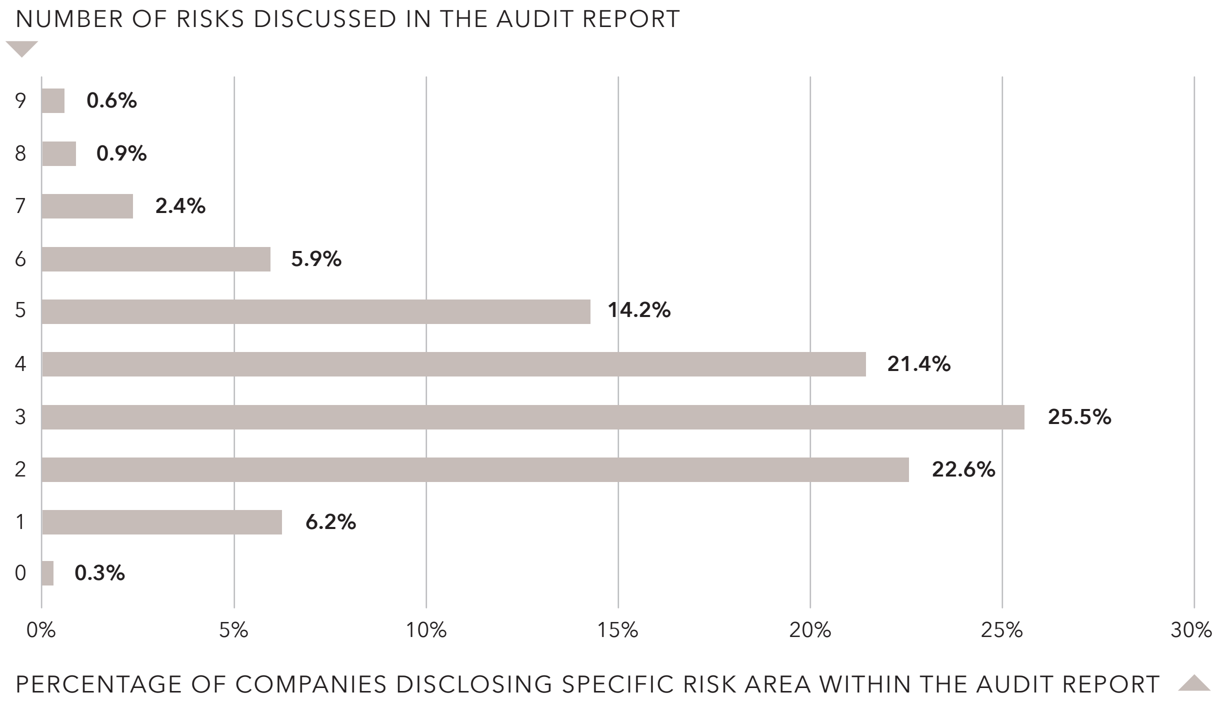
Anything you would do better next time?
Having just completed the 2016 financial year (it was the 2015 financial year report that won the award) we were undoubtedly more efficient this time around. In year one there was a degree of corporate nervousness, and team inexperience, in particular about the way we expressed the assurances we had obtained on each of the risk areas. Consequently we drafted and re-drafted some of these sections several times. This year I felt we were all more experienced and confident in applying the new standards.

BENCHMARKING

The number and type of risks disclosed are outlined below to help with benchmarking of audit reports and company disclosure. Data by sector is available on the web: icaew.com/extendedauditreport. While it is important that each audit report be bespoke and unique to the company, information about risks across a number of different companies can be helpful for first time adopters.

KEY AUDIT MATTERS – RISKS

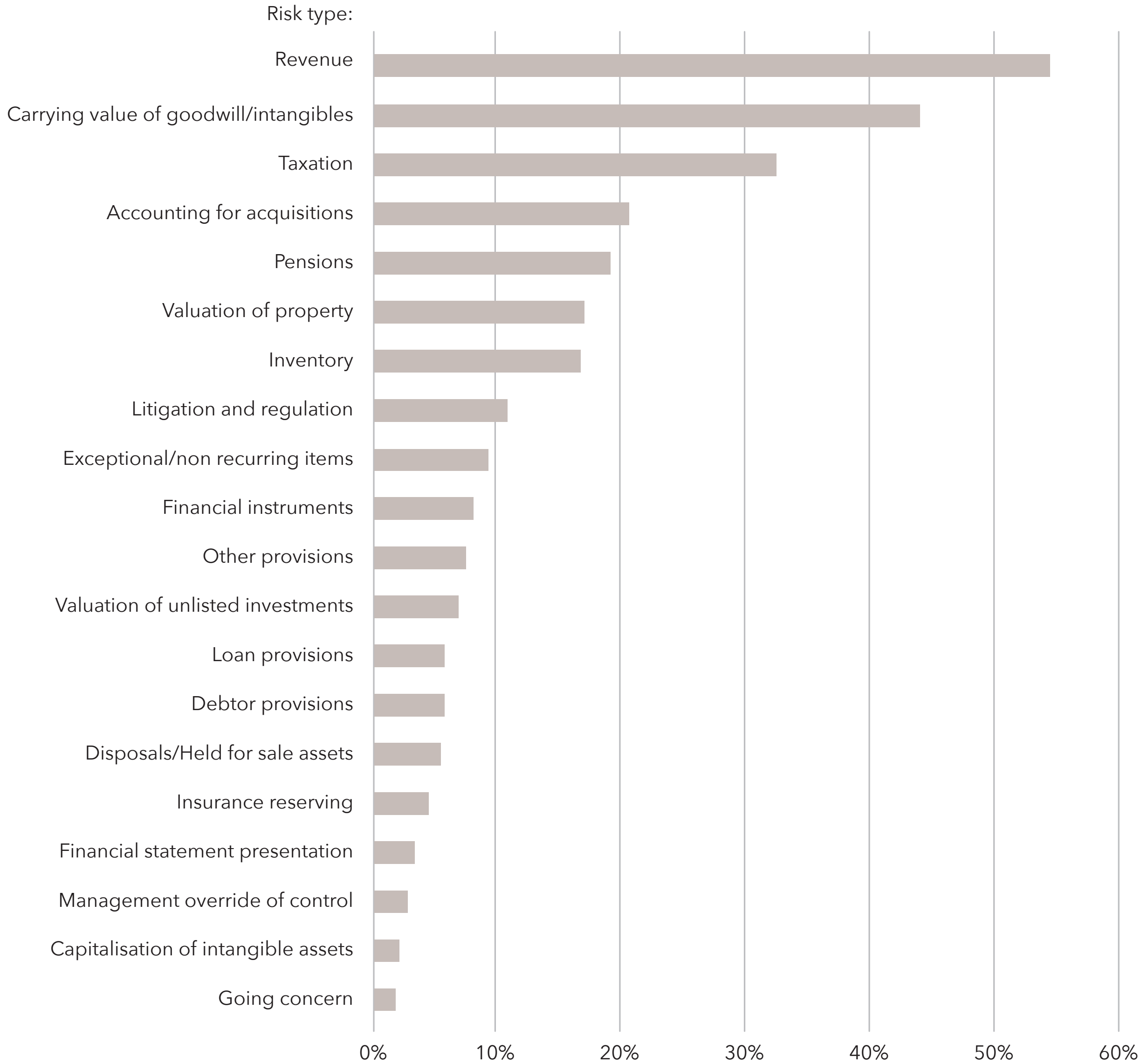
NUMBER OF RISKS



Source: Deloitte Survey of 2015 year ends June 2016

TYPE OF RISKS

PERCENTAGE OF COMPANIES REPORTING SPECIFIC RISKS



Source: Deloitte Survey of 2015 year ends June 2016

Large companies in the UK mostly report two to four KAMs and the majority include revenue recognition. Goodwill and intangibles along with tax are also popular, but there are also another 17 categories for KAMs reported showing the range and bespoke nature of extended auditor reporting.

As the UK experience of this reporting is for the largest companies, modified opinions or emphases of matter are rare. In these circumstances reports follow the requirements of the relevant ISAs which may preclude reporting KAMs in certain circumstances.

THE IMPACT OF EXTENDED AUDIT REPORTS ON COMPANIES, MARKETS, AUDITOR BEHAVIOUR, AUDIT COMPETITION AND CHOICE

Many have welcomed the UK extended audit report, including the FRC (the regulator in the UK).

> ‘ ***We welcome the continuing development of good quality auditor reporting and support the trend towards more granular (but still concise) descriptions of risk, the more transparent and accessible reporting of audit findings, and the disclosure of materiality.’***
>
> Quote from FRC Extended auditor’s reports a further review of experience (January 2016)

> ‘ ***We think the new information may be helpful in prompting better dialogue between companies and their shareholders on accounting and audit issues. We also suspect that companies may be prompted to provide better disclosure on matters highlighted in the auditor’s report, provided auditors fulfil the spirit of the new requirements.’***
>
> Quote from Citi Research Equities Western Europe Report 27 March 2014

However, the academic research to date does not find it easy to quantify the impact of the extended audit reports:

One study (Lennox et al 2015 and subsequently 2017) reported that the additional disclosures were not incrementally important to the market, but also did not increase audit fees. Another (Reid et al 2015) showed that disclosures positively affected audit quality and increased audit fees only marginally. The third (Gutierrez et al 2015 and subsequently 2016) reported no effect on audit quality and an association between audit fees and the number of risks identified by the auditor. [1]

Reid et al (2015) however found that:

> ‘ ***Abnormal trading volume significantly increased following the implementation of the new [auditor and audit committee report] disclosure regime ... Overall, it appears that additional required disclosures from audit committees and auditors provide useful information to investors.’***

And Lundgren et al (2016) say ‘Based on the responses of 100 young Swedish non-professional investors, we found that the new changes to the audit report, as we presented them, had a positive effect on the young non-professional investors perception on the audit report. Of the respondents, 64% viewed the new audit report as significantly more informative than the current Swedish audit report.’

EXECUTIVE DIRECTORS

Views from executive directors on extended audit reporting vary, ranging from those that are content or have even welcomed openness from their auditors to their shareholders on the most significant risks affecting the financial statements, to those that are reluctant to see disclosure of any more than the required minimum.

In the main, executive directors accept what is said because it is factual (this is the risk that the auditor documented on their audit files and this is what they did about it). However, the high quality and depth of UK reporting to audit committees helped. They were already seeing this kind of information, and so the new reporting contained no surprises for directors.

1 Bedard et al Does recent academic research support changes to auditor reporting standards? Jan 16 Accounting Horizons p263

Further changes in attitude will be driven by the requirements of the shareholders themselves: for example reporting more detail on findings.

AUDIT COMMITTEES

Audit committee members (who, in the UK, include independent non-executive directors) have differing views on long-form reporting. Some view the disclosure of significant risks as being a matter for the board/audit committee rather than the auditor. Others have welcomed the changes, and have taken the opportunity to improve their own disclosures in this area. Attitudes are affected by different corporate governance regimes around the world: the level of audit committee disclosure of audit risks varies and may be significantly different from that required under the UK Corporate Governance Code.

INVESTORS AND ANALYSTS

The feedback from the investment community on extended audit reporting has been extremely positive.

> ***'The investor community has welcomed and embraced the changes the FRC introduced as they have significantly improved the transparency and value of the audit.'***
>
> Liz Murrall, Director of Stewardship & Reporting at The Investment Association, said on 26 November 2015

(for example NAPF 2014 AGM Season Report http://bit.ly/2t73urY) It has provided investors with additional insight into the audit and they naturally report that they would like even more information, for example the auditor's findings in relation to the identified risk areas, and how cautious or aggressive the directors' estimates and judgements are.

Some investors say that they would like more information on the scoping of the audit and more detail on materiality, both of which, as discussed above, are additional requirements of the previous UK standard and will continue to be required in the UK under ISA 701. The disclosures in UK audit reports about materiality inevitably generated some interest, particularly immediately following the introduction of the requirement as there is information that is relatively easy to summarise, such as what benchmark is used to determine materiality and what percentage has been used for that benchmark. Investors may use this information to challenge the judgements made by auditors, such as why some auditors accept directors' non-GAAP profit measures while others do not adjust PBT in determining materiality, as well as the percentages used. Auditors have often sought to disclose more information than the overall financial statement materiality, such as the range of component materialities used and the threshold for reporting errors to the audit committee. However, for example, some investors would also like to see performance materiality disclosed in the audit report – this is not typically disclosed as it is a difficult concept to explain succinctly and often this will just be a set percentage of overall materiality.

While the requirement to disclose materiality and how the audit was scoped is not a part of ISA 701 issued by the IAASB, auditors outside the UK may choose to include such disclosures to provide further context to their discussion of the KAMs.

AUDITOR BEHAVIOUR

Auditors in the UK have fully embraced extended auditor reporting and continue to innovate year on year, with best practice still being developed.

The issue of an extended audit report does not generally change how the audit is performed. It is merely reporting information that is already available as part of the existing audit process. However, KAM reporting has forced auditors to clarify the reporting of their key risks so that they are more focused on the entity. The risks now included are considerably more detailed than originally as many have sought to raise the bar. Responses to reported risks need to be credible to show that the audit has been robust and this has led to more focus on use of innovative techniques (such as analytics) accompanied with tests of controls.

Auditors have, naturally, looked at other firms' reports for examples of practice and what they can glean about others auditors approach to materiality. Competition has also been helped by more insight into how auditors compare enabling anyone to benchmark risks that have been identified to others in the similar sector and the depth of the response.

REGULATORS

The focus of regulators in relation to enhanced audit reporting to date has been consistency between the content of the reports and the audit documentation, including the risks identified and the work performed.

In the EU, where from June 2016 additional requirements for auditor reporting beyond ISA 701 have been mandated, regulators will have a key role in determining whether the relevant EU legal requirements have been appropriately interpreted by individual audit firms. It is unclear how this will be approached and regulators will also need to consider how the requirements have been interpreted by other EU regulators.

Ultimately, there may be a move by regulators to incorporate what are seen as best practice innovations by audit firms into auditing standards. At present their appetite for doing so seems very small indeed.

OTHER GOVERNANCE REGIMES

The IAASB model is being applied internationally, however experience and outcomes vary.

The Corporate Governance regime is well developed in the UK: in parallel with the requirement for enhanced audit reports, audit committees are also required to report on their 'significant audit issues'. Audit committees may wish to do this even in countries where there is no such requirement to show that their responsibility has not been passed over to the auditors.

Territories are unlikely to have governance or specific regulatory issues that will prevent the ISAs being fully adopted. However, there may be cultural differences that impact how a particular territory embraces the new rules.

The example of Holland illustrates this:

In Holland extended audit reports are sometimes considered to be more standardised than in the UK – particularly across certain industries. There has also been a 'very limited' response from the general public/investors to the new style of reporting – certainly a lot less than we have in the UK, perhaps in part as a result.

In the US the PCAOB has issued a new auditor reporting standard which includes reporting 'Critical audit matters', applying some of the features of extended auditor reporting to the US market.

In consideration of the variety of governance regimes internationally this report reflects and focuses on experience in the UK.

4. Making audit reports as insightful as possible

Given that the UK was the first country to introduce long-form reporting, UK experience may be informative to companies and auditors in other countries.

Overall the UK regulatory approach has typically been to encourage client-specificity within an overall framework rather than provide a strict set of steps or rules. For example, a minimum or recommended number of KAMs is not required, rather leaving this to the engagement team based on the client's specific circumstances. This approach affects the type of insights that can be provided in response to questions from other jurisdictions, which we have summarised below in the following hints and tips.

One other matter that practitioners may wish to consider is whether to take risk management advice as part of the plan to implement the new standard. In particular, practitioners may want to consider matters such as the following:

- extent of adoption, including the extent to which early adoption may be seen as pre-empting local standard setters and regulatory recommendations;
- local jurisdictional requirements and/or legal implications;
- engagement letter considerations; and
- application of further quality control policies and procedures.

Notwithstanding, it is helpful to note that while academic research indicates that KAMs have increased transparency and may have some effect on investor decisions, this has not led to fundamental changes in audit.

12 HINTS AND TIPS

1 Early engagement with clients is critical
The directors need to understand the rationale for the KAMs being included in the audit report, particularly in sensitive areas. They may also want to consider the impact on their own disclosures in the annual report and the audit committee may be required to choose to comment on how they have responded to these matters. A recommended approach is to draft the audit report early, based on the results of the previous audit together with any expected changes for the current audit. Clients will then have an opportunity to get comfortable with how key matters are disclosed in the audit report and think about their own response.

2 Think about the audience for the report
The report is addressed to people who may not be experts in accounting and auditing. Don't use a lot of audit, accounting or sector-specific terminology that may not be easily understood or make the audit report too technical.

3 Make KAMs specific to the entity and the sector it operates in
If the KAMs and responses could apply to any entity in any sector, it may not be clear that the auditor has really understood the key issues facing that entity and imply that the audit has not been tailored accordingly. For example: referring to 'inventory' as being the KAM when the specific risk is 'recoverability of inventory.

4 Consider existing audit reports in the same sector
It may be helpful to refer to other audit reports in the same sector to compare the proposed audit report to similar entities. Although the report needs to be bespoke to the entity, reading other examples may give ideas for how better to articulate KAMs and audit responses.

5 **Don’t write the reports in isolation**
Use the combined and extensive knowledge of the audit team to ensure the report properly reflects the audit and includes the most important insights. Writing the report shouldn’t be a separate exercise, it should build on other communications in the audit, such as the audit plan and report to the audit committee. Explaining why the KAMs have changed from one year to the next may be helpful.

6 **Be precise when describing the response to the risks**
For example, if you test controls at some but not all entities in a group, don’t imply that controls testing was performed for all group entities. Similarly, if you involve specialists to respond to a risk, clearly specify which areas they worked on rather than implying they were involved in all aspects of the risk.

7 **Do your audit justice**
The extended audit report is a way to showcase your audit and share the important knowledge and insights you have gained. Auditors have unique and privileged access to all parts of a company and this enables them to have a well-informed perspective on the issues a company faces. The extended audit report is a way to share this valuable perspective with shareholders.

8 **Showcase your audit innovation**
Use the audit report to demonstrate the quality of the audit and any innovations and progress in process. The extended audit report provides an opportunity to describe new and innovative auditing techniques, such as using data analytics when appropriate.

9 **Integrate parts of the report where possible**
We don’t conduct audits in silos, thinking separately about risks, materiality and scoping and never connecting the parts, so we shouldn’t draft our extended audit reports this way. For example, when describing which locations/components were visited by the engagement team, link this to a particular KAM, if this was the reason for the visit; if specific materiality has been selected for a particular account balance, make the link to any related KAM.

10 **Complete the story**
Step back and consider whether your audit report tells the full story of the audit. This may be in the way materiality and audit scoping is described and integrated with KAMs. It may be in the inclusion of findings (if the auditor decides to go beyond what is required in the standard, for example in response to local legislation) in the response to each KAM.

11 **Be transparent**
If findings or observations are included (as they will be required to be, where relevant, for certain entities under the new EU rules), be transparent. Don’t be afraid to describe the thought process, discussions with management and rationale behind the end results.

12 **Make your report accessible and interesting**
Consider ways to make the report easier to navigate and visually interesting. As extended audit reports are inevitably longer, consider giving an overview of the KAMs and, if relevant, materiality and scoping at the beginning of the audit report. Consider including charts – for example as part of the description of a KAM – to make the report more interesting and easier to read.

FINDINGS AND KEY OBSERVATIONS

While the inclusion of findings in the audit report appears to be popular with investors, it is not universally so among companies and the profession. However, from 2017, EU law will require the inclusion of 'where relevant, key observations' in the audit report for certain entities, but it is an open question as to what this means. In addition, ISA 701 includes application material that states that the 'outcome of the audit' may be included in the response to the KAMs. Further guidance in this area may be provided at the local standard-setter level, but it may also be left up to the discretion of the profession to determine how the requirement is addressed. Whatever happens, it will undoubtedly be impacted by the appetite of investors.

Notwithstanding the forthcoming requirement to report on key observations, a number of auditors have already chosen to include findings or observations in their reports, although the level of detail included in these findings can vary considerably. While some reports include specific details about how the assumptions compare to other benchmarked companies, details of any audit adjustments for the KAMs, or how the client's estimate was optimistic or cautious, the majority of reports include less detailed findings, for example stating that the audit procedures were performed without any exceptions being noted. This highlights the challenges faced when trying to draft a meaningful, helpful outcome, without being ambiguous or misleading, or, worse still, giving a mini-opinion on individual risks.

SMEs AND SCALABILITY

From a practitioner point of view, producing the extended audit reports has been a fairly steep learning curve. The profession in the UK embraced the new requirements with a great deal of enthusiasm, but it has nevertheless taken time to implement them to their full potential. This is evidenced by the FRC's view that there is a 'continuing development of good quality auditor reporting' as described in their *Extended auditor's reports: A further review of experience* issued in January 2016. It has been a journey of experimentation and innovation, listening to feedback from shareholders and other stakeholders about what they liked and where they thought the reports could be improved.

Those issuing extended audit reports for the first time, whether because they are now required to under the revised UK auditing standards, or because they have adopted the revised international standards and/or new EU auditor reporting requirements, will face similar challenges. In the UK, the broader scope of the reporting requirements means that the number of entities who will need to issue extended audit reports will grow significantly. The international standard applies to listed companies, but countries where the international standard is being adopted for the first time may also face a voluminous number of first-time reports, depending upon whether their local rules and regulations expand the scope of applicability to other companies too. Exposure to the requirements for the first time, coupled with issuing potentially significant volumes of extended audit reports, is likely to result in a number of challenges for practitioners in terms of making them specific, consistent and to a high standard.

As described earlier, delivering a high quality, bespoke and insightful audit report is an important goal. However, in reality, some element of pragmatism may be appropriate when faced with a significant volume of reports. For example, in certain industries, there may be a large number of entities which are very similar in organisation structure and operations. In these situations, it is worth considering whether, by their very nature, these reports are likely to have much more standardised KAMs. In such situations, it may be entirely appropriate to manage the preparation of these reports by having a 'suite' of standard KAM examples for that industry. While this may feel like a fairly controversial approach, especially given the impetus on making these reports specific to each entity, the cost/benefit of doing so in certain situations cannot be ignored.

A similar approach to scalability could also be considered for a practitioner's central review processes around the extended audit reports, by ensuring that the review process is structured to focus on the most important areas and not trying to achieve the impossible to the extent that it leads to diminishing returns.

For larger entities, cost for the auditor has been less of an issue as the relative extra cost of producing an enhanced audit report for a larger listed company is relatively small. However, it may be more of an issue for much smaller companies where the audit fee is lower. In the event that there are significant extra costs, UK auditors have found it helpful to discuss them with the client well in advance.

5. Developing practice

THE FUTURE

So what next? The desire for transparency and openness is getting stronger, not only in audit reporting but in corporate reporting as a whole. We need to ride this momentum and look for ways to make the extended audit report concept even more useful. Possibilities include:

- Providing a summary audit report with the preliminary announcement (which the FRC is exploring) – many investors have told us that the extended reports are useful but come after the fact. Having a version of the report at the preliminary announcement could make it more useful for real-time investment decisions.
- Providing an extended interim review report that includes a summary of where we focused our interim review work and, potentially an indication of the areas we are potentially going to focus on as part of the audit.

Another area where audit reporting could develop is in the idea of providing continuous assurance. As people demand more and more real-time information and companies embrace real-time digital reporting, could assurance follow suit?

Best practice will emerge over time and is likely to be replicated in the majority of reports, and as the revised ISAs introduce new mandatory formatting and text requirements that look set to introduce more generic text, ultimately a general consistency of approach may therefore result.

Clearly there are obstacles to overcome relating to all of these possibilities, but the key is that we keep an open mind to what is possible. 10 years ago, the idea of disclosing in the audit report the key decisions and findings of the audit would have seemed impossible!

Set out below are some important considerations for practitioners and stakeholders in the extended audit report so they will continue to be insightful in the future.

REGULATION

- Regulators should allow diverse practice to develop to keep auditor reporting bespoke, fresh, relevant and dynamic, promoting competition between firms.
- They should understand that the impact of long-form audit reporting on audit quality, company behaviour and reporting, markets, consumers and other stakeholders will determine how auditor reporting, and indeed auditing, should be developed in the public interest.
- Comparison with other, arguably more insightful, communications about businesses should help develop the promising levels of innovation and interest seen in the initial years of implementing enhanced reporting.

COMPETITION

- Competition should drive firms and companies to go beyond the requirements of the standards if this improves the quality of the report: consideration of materiality, for example, puts the reporting of scope and findings into context.

ENGAGEMENT

- Engagement beyond the governance specialists with investors and analysts is vital.
- A forum to bring investors, audit firms, companies and regulators together might help improve understanding and develop innovative practice, keeping the reports fresh and combatting the regression to boilerplate over the years.
- Such a forum might also road-test reporting innovations: for example releasing the KAM with preliminary announcements has been requested and such feedback is helpful to explore the right developments.

DATA ANALYTICS AND THE NEW AUDIT

- Auditing developments, such as data analytics, will have an effect on extended auditor reporting: it may fuel greater diversity, but issues such as reporting findings without potentially misleading readers may need to be addressed by practitioners.

INTERNATIONAL IMPLEMENTATION CHALLENGES

An open discussion will help address the short-term challenges of implementing the new international standards, and ICAEW will continue to discuss these, and other, high level issues such as:

- Reporting consistency – Global implementation means there is quite a debate about whether a global format is used or whether individual countries are allowed scope to innovate.
- Time and training of staff – this should be less of an issue given the lead time, but it still does worry some implementers.
- Investor awareness, education and feedback – developing an open dialogue with investors is important to implement and improve extended auditor reporting globally.
- Risk management – especially in more litigious environments.
- Resistance from stakeholders, who may see little benefit from increased transparency.
- Company management influence on writing the reports – auditee companies are very interested in what is in the reports.
- Regulatory support – in the UK we have been very lucky that the profession and regulators embraced the new report, but more persuasion may be required elsewhere.

6. *Calls to action*

To build on the achievements of extended auditor reporting in the UK and implement and maintain it successfully around the world, everyone involved needs to continue the conversation and work together.

In particular:

1. Auditors should be courageous and do their audits justice – implementing the spirit of extended reporting: transparency in the public interest. Regulators should help by sharing best practice rather than highlighting bad practice, especially in the initial stages of implementation when everyone is learning.

2. Public interest entities should invest in their reporting as a whole, including the audit report so it tells a clear, concise and consistent story.

3. Investors need to use and analyse the audit report, and ask for the information they want, raising questions for the auditor at Annual General Meetings where possible. Investors should promote good practice, and even sponsor awards!

4. Governments should permit and encourage transparency.

5. Professional bodies should also promote best practice and help train practitioners and business in the new requirements.

6. Finally, academics should use the rich data in extended audit reports to help shine a light on audit quality and the media should take an interest in what auditors are saying about public interest entities – everyone in society is a stakeholder!

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