

March 2015

Extended auditor's reports

A review of experience in the first year

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Financial Reporting Council

Extended auditor's reports: A review of experience in the first year

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EXECUTIVE SUMMARY

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The Financial Crisis of 2008 brought into sharp focus the concerns of investors and others about the effectiveness of company stewardship generally and about the effectiveness of the audit in supporting this. In particular, concerns were raised about whether the binary (i.e. pass/fail) auditor's report continued to be fit for purpose in providing adequate transparency about the audit and the auditor's insights about the company, based on its work. The FRC's response was to seek to improve company stewardship through coordinated changes to the UK Corporate Governance Code (the Code) and to Auditing Standards.

With respect to the Code a new Main Principle was introduced “**The board should present a fair, balanced and understandable assessment of the company's position and prospects**”, with a supporting provision requiring the Board to state that the Annual Report and Accounts is fair, balanced and understandable. A further supporting provision was also introduced into the Code requiring the Annual Report of a company to include a separate report describing the work of the Audit Committee which, among other things, describes the significant issues that the Committee considered in relation to the financial statements and how these issues were addressed. The FRC has reported on the implementation of the changes to the Code in “Developments in Corporate Governance and Stewardship 2014” published in January 2015.

The FRC's response with respect to audit was to introduce new requirements for auditor's reports on companies subject to the Code, with effect for periods commencing on or after 1 October 2012. The auditor was required to report by exception on the “fair, balanced and understandable” statement and on the report on the work of the Audit Committee, and to provide greater transparency about the audit. Greater transparency was addressed by requiring auditors to include within their reports:

- a) A description of those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;
- b) An explanation of how the auditor applied the concept of materiality; and
- c) A summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement described in (a) and the concept of materiality as described in (b).

The Auditing Standard encouraged auditors to be entity specific (i.e. to provide explanations that can be related directly to the specific circumstances of the audited entity rather than generic or abstract explanations expressed in standardised language). It also encouraged the auditor to coordinate descriptions of overlapping topics and to avoid duplication of reporting about them whilst having appropriate regard to the separate responsibilities of the auditor and the Board for directly communicating information primarily in their respective domains.

The Survey addresses the implementation of these changes to UK Auditing Standards which have given rise to what has become known as “the extended auditor's report”.

Scope of Survey of extended auditor's reports issued in the first year

With respect to the new auditor's report requirements, outlined above, the FRC deliberately chose not to publish detailed illustrative examples of auditor's reports. The FRC was concerned that publishing such illustrations would establish norms that might stifle innovation. The FRC chose, therefore, to allow individual engagement partners and audit firms to innovate as they thought fit within the framework of the

new requirements. The Survey explores both whether the new requirements appear to have been complied with and areas of innovation.

Between July and September 2014 the FRC carried out a detailed analysis of 153 extended auditor's reports (63 of which were of FTSE 100 companies) that had been published at that time. Almost all of these reports (147 out of 153) were issued by the four largest audit firms.

The analysis was performed by staff of the FRC reading both the extended auditor's report and the report of the Audit Committee and responding to a number of questions about what they had read. Some of the questions required the recording of objective information such as the number of risks reported by the auditor. Other questions involved making subjective judgments such as the extent to which the description of a risk described specific circumstances of an entity or were written in generic terms.

Although the subject matter of this Review is the extended auditor's report, there is some overlap between the reporting of risks by the auditor and the reporting of significant issues by the Audit Committee. This Review includes some (necessarily subjective) observations concerning how well the descriptions of risks in the extended auditor's report complemented the description of the equivalent significant issues provided by the Audit Committee.

Overview of Survey findings

The Survey confirmed that auditors appeared not only to have met the new requirements but in many cases had made, sometimes quite radical, further changes to auditor's reports going beyond the changes required by the FRC. A particular conclusion of the Survey was that each of the audit firms had adopted different approaches to the extended auditor's report and had, therefore, been innovative in different ways. The FRC considers the extent of innovation and the diversity of approaches adopted to be very encouraging.

Significant innovation was found in the following areas:

- Disclosing the materiality benchmark used.
- Disclosing the magnitude of unadjusted differences being reported to the Audit Committee.
- Reporting of detailed audit findings with respect to identified risks.
- Experimentation with detailed broader explanation of the audit scoping process.
- Improved presentation of auditor's reports through the use of diagrams and graphs.
- Addressing going concern disclosures in auditor's reports.
- Locating the auditor's opinion at the beginning of the auditor's report rather than at the end.
- Moving generic descriptions of the scope of an audit to a web-site.

The Survey did, however, reveal areas where further improvements might be made. These areas are:

- Increasing the granularity of risk reporting (i.e. being as entity specific as possible).
- Improving the discussion of the auditor's application of materiality and why a particular benchmark or level was chosen and addressing other aspects of materiality.
- Making a clearer linkage between the discussions of risks and materiality and the description of how these influenced the scope of the audit.

The IMA¹ Auditor Reporting Awards

An important source of evidence of investor views regarding extended auditor's reports can be found in the comments of the judges of the Investment Management Association's Auditor Reporting Awards which were presented in November 2014. We have reproduced some of their observations many of which resonate with our own findings. For example, the judges:

- Liked risks that are entity specific.
- Liked quantification of individual risks so that investors can assess their materiality.
- Would like to see more information about why the level of materiality was chosen.
- Liked discussion of what the auditor found, whether the company's approach was satisfactory or whether the auditor questioned management's judgment.
- Liked reports that had an engaging layout, particularly through use of tables and charts.

The judges also stated that auditor's reports which included the auditor's findings and graduated those findings to be the most insightful and engaging for investors.

Discussions with investors and audit firms

Following completion of the Survey we had a number of meetings (between October 2014 and January 2015) with investors and audit firms to both discuss our findings and to seek their views as to how well the first year of extended auditor reporting went from the perspective of their firm or organisation and their plans and aspirations looking forward to the second year and beyond.

There are a number of perceived improvements that could be made, working within the framework of the new requirements that are recognised by both investors and audit firms. These include:

- Improving the granularity of the reporting of risks.
- Providing more information to explain why a particular materiality benchmark was chosen.
- Disclosing more information about qualitative aspects of materiality.
- Providing clearer explanations as to how the audit scope was affected by the auditor's risk assessment and materiality judgments.
- More disclosure of comparative information and explanations of changes from one period to another.

The investors and audit firms also suggested some more aspirational changes which include:

- Introducing a discussion within either the auditor's report or the Audit Committee report as to why an auditor raises a risk that is not also dealt with by the Audit Committee in its report.

¹ The IMA is now known as The Investment Association

- Including the new information provided in the extended auditor's report in the preliminary announcement.
- Providing an opportunity for stakeholders to challenge the proposed scope of the audit by publishing the audit plan in advance of the year end.
- Providing more encouragement for the reporting of issues arising from the quality of company's systems.

One of the more interesting innovations has been the reporting of findings by certain audit engagement partners. One firm has announced an intention to adopt this practice more widely. Although investors are generally supportive of this practice, we have heard that some Audit Committees are resistant to such a development and that some audit firms would like to see a safe harbour provision put in place for the protection of auditors.

Findings of the FRC's Audit Quality Review Team

Although the overall message from this Review is upbeat regarding progress made by the audit firms in writing the new style auditor's reports, a cautionary note is emerging from the work of the FRC's Audit Quality Review Team.

During the FRC's Audit Quality Reviews, it assesses whether the descriptions of work undertaken by auditors in extended auditor's reports are consistent with the evidence of the work actually performed. In some instances the FRC has identified inaccuracies in the auditor's descriptions of the nature or extent of the audit procedures performed. The FRC has brought these matters to the attention of the relevant audit firms and reminded all the major firms of the importance of ensuring that their auditor's reports accurately reflect the work performed.

The FRC's objective to maintain the momentum of this initiative

From the FRC's perspective, the response of audit firms to these changes has been most encouraging. Each of the largest audit firms has adopted a distinctive approach to meeting the new requirements of Auditing Standards and there has been a notable absence of the use of standard language (boiler-plate) in almost all of the auditor's reports that we looked at. Many audit firms have demonstrated considerable innovation by going further in seeking to improve their auditor's reports than the minimum requirements established by the FRC in the Auditing Standards.

Audit firms and audit engagement partners are, of course, dependent upon feedback from investors and other users of company Annual Reports to inform them about the usefulness of their extended auditor's reports. Feedback from investors as to what they find useful and what is of less use will be of critical importance going forward. To make investor feedback more widely available we have included within this Review feedback from the judging panel of the IMA Auditor Reporting Awards and comments we have received in our one on one meetings with various investors.

The FRC hopes that publishing this Review will act as a catalyst to maintain the momentum of the initiative in the UK and Ireland in the second year and also have an influence on international practice as it evolves in response to the implementation of the International Auditing Standards on auditor reporting which have recently been issued by the International Auditing and Assurance Standards Board (IAASB).

THE SURVEY OF EXPERIENCE IN THE FIRST YEAR

Background to the development of the extended auditor's report in the UK

In 2012, arising from its work on audit quality the FRC was aware of the concerns of users of auditor's reports that the traditional binary (i.e. pass/fail) audit opinion, supported by legalistic caveats and provisos, may no longer be fit for purpose.

In 2007 the FRC issued a Discussion Paper “**The auditor's report: A time for change?**” which explored a number of possible options. Arising from this discussion paper, the FRC introduced requirements for the auditor's report to explicitly address those matters where the auditor is required to report certain matters by exception, by requiring the auditor's report to describe them and to state that the auditor has nothing to report in respect of them. A further innovation introduced at that time was to make the auditor's report more concise by enabling the detailed description of the scope of an audit to be excluded from the auditor's report and instead to be cross referred to on the FRC's web-site.

These changes were seen as being the first phase of the FRC's work on the auditor's report. The second phase was to undertake research to better understand what could realistically be done to make auditor's reports more informative. In the feedback statement on its proposals, in 2008, the FRC stressed that the revised auditing standard did not preclude auditors from including additional comment in the auditor's report to highlight matters which they regard as relevant to a proper understanding of their work. The FRC amended its auditor reporting standard to facilitate the inclusion of such additional comments in the auditor's report. However, this did not seem to stimulate additional comments being made in UK auditor's reports.

The aftermath of the Financial Crisis of 2008 significantly increased the intensity of the focus on the effectiveness of company stewardship and the adequacy of the communications to the market made by both Audit Committees and auditors. The FRC therefore embarked on further consultations and evidence gathering. In early 2011, arising from feedback to its Consultation Paper “**Effective Company Stewardship – Enhancing Corporate Reporting and Audit**” the FRC concluded, among other things, that:

- More needs to be done to demonstrate that auditors are achieving the fundamental purpose of an audit – namely to carry out an independent check into whether a company's financial statements, including the decisions, judgments and estimates involved have been properly prepared and are fair and balanced.
- Auditors can and should provide increased insight into the audit process so as to re-assure users of financial statements that all material matters have been properly disclosed.
- It would be appropriate to revise the Auditing Standards that govern both reporting by auditors to Audit Committees and reporting to users in the auditor's report, to make the contribution of auditors to stewardship more transparent.

Overview of the changes made to the Code in 2012 (See Appendix 2)

In 2012, arising from its 2011 Consultation, the FRC made simultaneous changes to the Code and to the Auditing Standards to accomplish the above objectives. With respect to the Code a new Main Principle was introduced: **“The board should present a fair, balanced and understandable assessment of the company’s position and prospects”**. A new provision in the Code requires the directors to make a statement in the Annual Report that “they consider 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”.

Another new Code Provision requires the Audit Committee, where requested by the Board, to “provide advice on whether 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”. A further new Code Provision requires the Annual Report of a company to include a separate report describing the work of the Audit Committee (the Audit Committee Report) including the significant issues that the committee considered in relation to the financial statements and how these issues were addressed.

In parallel with these changes, the auditing standard that governs reporting by auditors to those charged with governance (i.e. the Board and as applicable the Audit Committee) was revised to require the auditor to communicate to the Audit Committee the information the auditor believes will be relevant to the Board and the Audit Committee in fulfilling their responsibilities, including their new responsibilities relating to the application of the new Code Principle and related reporting. Such communications by the auditor should enable the Board and Audit Committee to understand the rationale and the supporting evidence the auditor has relied on when making significant professional judgments in the course of the audit and in forming an opinion on the financial statements.

Overview of the changes made to the UK auditor’s report (See Appendix 1)

In making the changes described above, the FRC took account of the widely held belief that primary responsibility for disclosing information about a company appropriately rests with the company rather than with the auditor. Disclosure of information about the company, in connection with issues considered by the Audit Committee (including those drawn to its attention by the auditor), should, therefore, be the primary responsibility of the company, including as necessary the Audit Committee rather than the auditor. However, the auditing standard governing auditor’s reports was revised to require the auditor to report by exception if the Board’s statement in the Annual Report is inconsistent with the auditor’s knowledge acquired in the course of performing the audit or the matters disclosed by the Audit Committee in the section of the Annual Report describing its work do not appropriately communicate matters communicated by the auditor to the Audit Committee. The auditor is, therefore, required to report such matters in its report should the Audit Committee fail to do so.

On the other hand, when considering the potential impact of the above changes the FRC concluded that Audit Committees may be reluctant to have primary responsibility to describe matters concerning the conduct of the audit in their report. The FRC, therefore, amended the auditor reporting standard to require the auditor’s report to:

- a) Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;
- b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; and
- c) Provide a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement and the auditor's application of the concept of materiality, as disclosed in the auditor's report.

To encourage innovation, the above requirements were deliberately set at a high level. The only prescriptive requirement is that the discussion of materiality must specify the threshold used by the auditor as being materiality for the financial statements as a whole.

Extent of the survey

Our Survey encompassed the Audit Committee reports and auditor's reports of 153 companies. With two exceptions, the Institute of Chartered Accountants in England & Wales (ICAEW) and the Financial Reporting Council (FRC), these companies are listed on the UK's Main Market.

The 153 companies which we surveyed were selected from those Annual Reports that included extended auditor's reports which became publicly available during the period between July and September 2014. Although there was no particular science behind our selection we endeavoured to include companies from a wide range of industry sectors and to focus on auditor's reports of larger companies. For example 63 (41%) of the Annual Reports in our Survey were of auditor's reports of FTSE 100 companies. Arising from the timing of our Survey and our focus on the auditor's reports of larger companies, and as can be seen from Table 1, almost all of the auditor's reports we surveyed were issued by the four largest audit firms.

TABLE 1 Analysis of auditor's reports surveyed by audit firm and market

	FTSE	FTSE	FTSE	FTSE	TOTAL	TOTAL
	100	100	250 ²	250		
	No.	%	No.	%	No.	%
Deloitte LLP (Deloitte)	14	22	28	31	42	27
EY LLP (EY)	7	11	14	16	21	14
KPMG Audit Plc (KPMG)	15	24	22	25	37	24
PwC LLP (PwC)	26	41	21	23	47	31
BDO LLP (BDO)	1	2	2	2	3	2
Grant Thornton UK LLP (Grant Thornton)	-	-	2	2	2	1
haysmacintyre LLP (haysmacintyre)	-	-	1	1	1	1
Total	63	100	90	100	153	100

² To simplify the presentation the ICAEW and the FRC are included with the FTSE 250.

Table 2 provides an analysis of the companies surveyed by industry sector and audit firm.

TABLE 2 Analysis of auditor's reports surveyed by industry sector and audit firm

Sector	No. in sample from FTSE 350	Deloitte	EY	KPMG	PwC	Others
Banks & Financial Services	17	5	4	4	3	1
Basic Materials	5	-	-	3	2	-
Business Services	1	-	-	1	-	-
Commercial Properties	11	5	-	-	6	-
Construction Services	5	2	-	3	-	-
Consumer Goods & Services	30	9	6	3	10	2
Health Care	4	-	1	2	1	-
Industrials	17	8	1	6	2	-
Information Technology	7	1	2	1	3	-
Insurance	8	-	-	4	4	-
Metals & Mining	2	-	-	2	-	-
Natural Resources	19	8	5	1	4	1
Oil & Gas	2	-	1	-	1	-
Regulator/Professional Body	2	-	-	-	-	2
Retail	10	1	1	3	5	-
Support Services	7	-	-	3	4	-
Telecommunications	5	2	-	1	2	-
Utilities	1	1	-	-	-	-
All Companies	153	42	21	37	47	6

The Survey addresses separately each of the new requirements of the Auditor Reporting Standard:

- a) The reporting of risks;
- b) The reporting of materiality; and
- c) The description of the scope of the audit.

The Survey also addresses areas of innovation within the following four subject areas that go beyond the new requirements in the Auditor Reporting Standard:

- a) Going concern disclosures;
- b) Location of the auditor's opinion within the auditor's report;
- c) The use of standard language; and
- d) The use of diagrams and graphs.

Finally the Survey addresses how well the descriptions of risks in the extended auditor's report complemented the description of the equivalent significant issues provided by Audit Committees in their reports.

Reporting of risks

Number of assessed risks of material misstatement reported in the auditor's report

Table 3 analyses the number of assessed risks of material misstatement reported by audit firm, highlighting the highest and lowest numbers of risks reported. The number of risks reported ranged from 1 to 10 - the highest number of risks was reported in the auditor's report for Rolls Royce. It is interesting to note that each of the four largest audit firms reported more risks on average for FTSE 100 companies than for FTSE 250 companies.

TABLE 3 Analysis of risks reported by audit firm

Sector	Deloitte	EY	KPMG	PwC	Others
Highest number of risks reported	7	8	10	9	6
Sector in which the highest number of risks was reported	Consumer Goods & Services/Natural Resources	Industrials	Industrials	Insurance	Natural Resources
Lowest number of risks reported	2	1	1	3	2
Sector in which the lowest number of risks was reported	Commercial Properties	Information Technology	Insurance	7 various sectors	Banks & Financial Services
Range of risks reported	5	7	9	6	4
Average number of risks reported FTSE 350	4.0	4.1	3.6	4.9	3.8
Average number of risks reported FTSE 100	4.2	5.3	4.7	5.5	6.0
Average number of risks reported FTSE 250	3.9	3.6	2.9	4.2	3.4

The reporting of standard risks in some auditor's reports

Some auditor's reports (routinely, but not exclusively, those from PwC) included one or both of the following "standard risks" as assessed risks of material misstatement:

- a) The risk of fraud in revenue recognition; and
- b) The risk of management override of controls.

PwC's basis for doing so was that it considered these to be important risks which merited being addressed in the auditor's report. Its view reflected the Auditing Standards deeming both of these to be significant risks i.e. "an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration"³.

However, it was not the FRC's intent that so called "significant risks" as defined in Auditing Standards should, as a matter of course, be presumed to be an assessed risk of material misstatement that is required to be described in the auditor's report⁴. The intent of the requirement was for the auditor to discuss in the auditor's report those risks which had the greatest effect on the audit strategy, resources and effort. The guidance to ISA (UK and Ireland) 700 notes that the auditor uses its judgment to determine which if any of the significant risks meet the criteria set out in paragraph 19A of ISA (UK and Ireland) 700.

In some instances these risks clearly had an effect on the audit strategy. For example, in PwC's auditor's report on GKN plc fraud in revenue recognition and PwC's response thereto was described as follows:

Area of focus	How the scope of our audit addressed the area of focus
<p>Fraud in revenue recognition</p> <p>ISAs (UK & Ireland) presume there is a risk of fraud in revenue recognition because of the pressure management may feel to achieve the planned results.</p> <p>We focused on this area because the timing of revenue recognition and its presentation in the income statement has inherent complexities and requires the Directors to exercise judgement.</p> <p>The complexities and judgement include, but are not limited to:</p> <ul style="list-style-type: none"> • the pricing of non-contractually agreed elements of revenue, such as rebates and on-going pricing discussions with customers; and • the recognition of revenue within specific revenue risk sharing partnerships (RRSPs) and bill and hold arrangements within the Aerospace segment. 	<p>As the foundation of the evidence we obtained regarding the revenue recognised during the year, we evaluated the relevant IT systems and tested the internal controls over the completeness, accuracy and timing of revenue recognised in the financial statements.</p> <p>We tested the timing of revenue recognition, taking into account contractual obligations, and in particular assessed whether the Group had appropriately recorded revenue based on whether complex contractual arrangements, such as bill and hold arrangements and long term contract accounting had been appropriately applied.</p> <p>We assessed management's judgements and validated their accuracy by agreement to post year end settlements reached with customers.</p> <p>We also responded to the risk that manual adjustments could override standard procedures to misstate revenue by auditing manual journals relating to revenue so as to identify unusual or irregular items.</p>
<p>Extract from PwC's auditor's report on GKN plc</p>	

In others, however, the risks did not appear to engender a response other than that which would ordinarily be required by Auditing Standards. An example illustrating this point can also be found in PwC's auditor's report on GKN plc:

³ Subsequent to the period covered by our Survey, we understand that PwC has decided to adopt a slightly modified approach to the discussion of these two significant risks in auditor's reports, in which they are addressed in the auditor's report without necessarily including them as assessed risks of material misstatement.

⁴ See paragraph 19A (a) of ISA (UK and Ireland) 700 (Revised June 2013) (See Appendix 1 where this paragraph is set out in full).

Area of focus	How the scope of our audit addressed the area of focus
<p>Risk of management override of internal controls ISAs (UK & Ireland) require that we consider this because management is in a unique position to perpetrate fraud as a result of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.</p>	<p>We assessed the overall control environment of the Group, including the arrangements for staff to whistle-blow inappropriate actions, interviewed senior management and the Group's Corporate audit function and reviewed the Board minutes of the Company.</p> <p>We examined the significant accounting estimates and judgements relevant to the financial statements for evidence of bias by the Directors that may represent a risk of material misstatement due to fraud. We planned unpredictability into our audit plan and executed procedures which included testing of immaterial items and performing procedures on out of scope balances.</p> <p>We also tested key reconciliations and journal entries to identify unusual or irregular items.</p>
<p>Extract from PwC's auditor's report on GKN plc</p>	

In the various tables that follow in this Survey, except where we use the term "Standard Risks", we are referring to all risks reported in the auditor's report.

Taking all companies in our sample the average number of risks reported is 4.2. Deloitte (4.0); EY (4.1); and KPMG (3.6) are below the average number of risks reported and only PwC (4.9) is above the average.

However, the data is affected by the inclusion in some auditor's reports (especially, but not exclusively, those issued by PwC) of standard risks. If the standard risks are removed from the analysis the average number of risks reduces from 4.2 to 3.5 with Deloitte (4.0); EY (3.8); and KPMG (3.6) all above the average and PwC at 2.9 being below the average. The fact that flexing the data by removing standard risks moves a firm from being the only one above the average to being the only one below the average indicates the significance of the inclusion of standard risks to our analysis.

Number of assessed risks of material misstatement reported by industry sector

In Table 4 we have analysed the number of risks disclosed by industry sector. We have analysed our sample between the FTSE 100, FTSE 250 and the total sample. Although we have analysed the number of risks for each sector by audit firm we do not include this analysis in this Survey because the sample sizes in a number of cases are so small the results may not be truly indicative of the risks reported in the sector by the various audit firms.

TABLE 4 Reporting of risks by industry sector

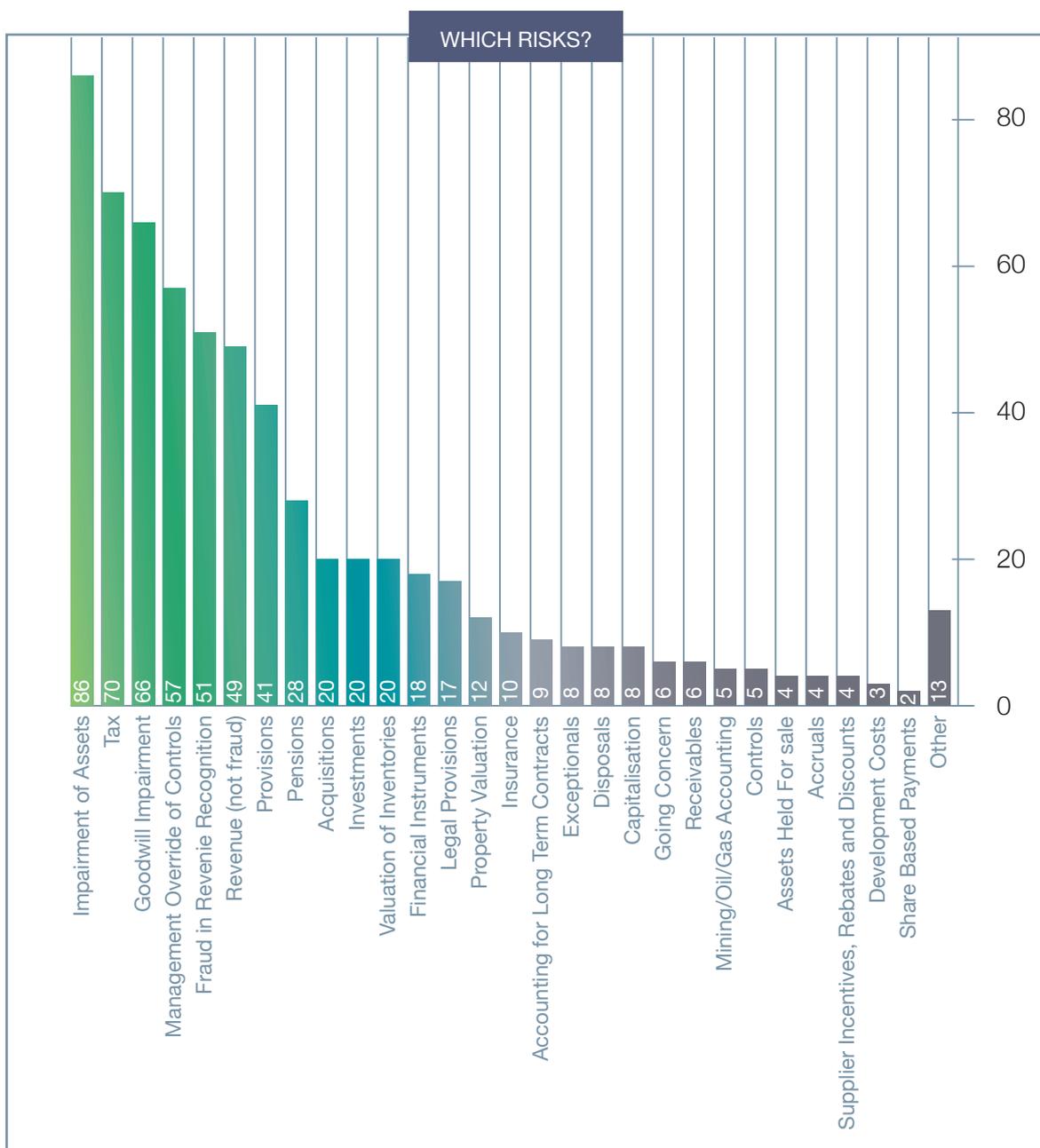
Sector	FTSE 100 companies			FTSE 250 companies			All (FTSE 350) companies		
	Number of companies	Number of risks reported		Number of companies	Number of risks reported		Number of companies	Number of risks reported	
		Total	Non-standard		Total	Non-standard		Total	Non-standard
Banks & Financial Services	5	5.8	4.8	12	3.4	3.0	17	4.1	3.5
Basic Materials	2	5.0	5.0	3	2.7	2.0	5	3.6	2.8
Business Services	1	4.0	4.0	-	-	-	1	4.0	4.0
Commercial Properties	2	3.0	3.0	9	3.8	2.4	11	3.6	2.5
Construction Services	1	2.0	2.0	4	3.0	3.0	5	2.8	2.8
Consumer Goods & Services	15	5.0	4.5	15	4.5	3.8	30	4.6	3.7
Health Care	3	4.7	4.7	1	1.0	1.0	4	3.8	3.3
Industrials	4	6.0	6.0	13	3.4	3.0	17	4.1	3.7
Information Technology	2	4.5	2.5	5	3.6	2.8	7	3.9	2.7
Insurance	5	5.4	4.2	3	2.7	2.0	8	4.5	3.4
Metals & Mining	-	-	-	2	4.5	4.5	2	4.5	4.5
Natural Resources	10	5.2	4.7	9	3.8	3.4	19	4.4	4.0
Oil & Gas	1	8.0	8.0	1	6.0	4.0	2	7.0	5.5
Regulator/Professional Body	-	-	-	2	3.0	2.5	2	3.0	2.5
Retail	6	5.3	4.6	4	3.4	3.0	10	4.7	3.6
Support Services	4	4.0	3.3	3	3.7	2.3	7	3.9	2.9
Telecommunications	2	6.5	6.5	3	4.7	4.0	5	5.4	4.4
Utilities	-	-	-	1	4.0	4.0	1	4.0	4.0
All Companies	63			90			153		
Average number of risks All sectors		5.0	4.5		3.6	3.0		4.2	3.5

It can be seen from Table 4 that the average total number of risks reported for companies from the FTSE 100 (5.0) is substantially higher than the total number of risks reported for companies in the FTSE 250 (3.6). It is possible that this reflects differences in the average size and complexity of FTSE 100 Groups compared to FTSE 250 Groups giving rise to a greater number of reported risks, but we have not been able to research this.

Which risks are reported?

As can be seen from the graph in Table 5 there is a broad range of risks reported.

TABLE 5 Analysis of reported risks



The 15 highest ranked risks reflect 565 instances of reported risks and comprise 87% of the total number of risks (650) reported by auditors in our Survey. Impairment of assets and goodwill represent 23% of the risks reported. It is perhaps surprising (in the context of FTSE 350 companies) that the next highest risk relates to taxation. However, a number of the taxation issues arise in overseas jurisdictions or relate to deferred taxation balances including the recoverability of deferred tax assets. Financial instruments at only 3% of the total may also be surprising. This seemingly low percentage may be accounted for by financial instrument valuation issues being coupled in our analysis with impairment considerations and perhaps the relatively small number of banks included within the Survey. “Management Override of Controls” and “Fraud in Revenue Recognition” are the standard risks discussed earlier in this Survey.

For illustrative purposes we set out below examples from auditor’s reports of descriptions of the top four non-standard risks:

Asset impairment (other than Goodwill)

Impairment of property, plant and equipment (charge in year £5.3m, closing net book value £268m)

Refer to page 44 (Audit Committee statement), pages 73 and 75 (accounting policy) and pages 79 and 84 (financial disclosures)

The risk –

The economic climate and levels of competition remain challenging for the Group. The Group has completed a Strategic Review, details of which were announced in the half year statement, and as a result has decided to close or curtail some of its operations. There is therefore a risk that the impairment charge may be misstated. Determining the level of impairment involves forecasting and discounting future cash flows and estimation of recoverable amounts which are inherently uncertain. This is one of the key judgmental areas that our audit has concentrated on.

Our response -

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

- In respect of assets within shops which continue to trade we critically assessed and challenged the Group’s impairment model. This included consideration of the discounted cashflow forecasts on a shop by shop basis and assessing the cashflow forecasts against the historical performance of those shops and against the Group’s budgets. We assessed the appropriateness of the discount rate including benchmarked it against similar national retailers. We also recalculated the impairment model to assess the sensitivity of the key assumptions including growth rate and discount rate;
- ...

Extract from KPMG’s auditor’s report on Greggs plc

Goodwill impairment

Area of focus	How the scope of our audit addressed the area of focus
<p>Goodwill impairment reviews</p> <p>We focused on this area because the Group carries significant goodwill and acquired intangible asset balances. There is judgement in the identification and aggregation of cash generating units (CGUs) and in the assumptions used in the annual goodwill impairment review.</p>	<p>We tested management's impairment analysis by examining their identification and aggregation of CGUs and by evaluating the underlying assumptions through assessment of forecast, market conditions and sensitivity analysis and through assessing the historical accuracy of forecasts and budgets. We assessed management's calculation of discount rates and perpetuity growth rates and we tested the integrity of the valuation model.</p>
<p>Extract from PwC's auditor's report on Pearson plc</p>	

Taxation

<p>The assessment of the carrying value of deferred tax assets for trading losses. We evaluated the integrity of the forecast models and considered the appropriateness of management's assumptions and estimates in relation to the likelihood of generating suitable future taxable profits to support the recognition of deferred tax assets. We evaluated the historical accuracy of forecasting and the integrity of the forecast models and as a result of these procedures, we formed our own view on the Group's capacity to get effective relief for tax losses over the forecast period.</p>
<p>Extract from E&Y's auditor's report on Intercontinental Hotels Group PLC.</p>

Revenue recognition

Risk	How the scope of our audit responded to the risk
<p>Revenue recognition on:</p> <ul style="list-style-type: none"> significant long-term contracts, due to the financial effects of judgments, including future milestone success, associated with determining the percentage of contract completion at the balance sheet date and risks associated with completing the contract; and delivery of goods, due to the complex contractual terms with regards to the transfer of risk and reward and therefore the appropriate point at which revenue should be recognised. 	<p>Our audit work assessed the adequacy of the design and implementation of controls over long-term contract accounting. We reviewed the contract risk registers and evidence for the progress made against the contract to confirm that revenue and profit recognised to date are based on management’s current best estimate of the degree of contract completion. We understood and challenged management’s assumptions by referring to evidence including signed contract terms and latest project status reports, and discussing contract progress and future risks with contract engineers. We also assessed the reliability of management estimates through consideration of the historical accuracy of prior period management estimates.</p> <p>In response to the risk of inappropriate revenue cut-off arising from complex contractual terms, we reviewed contractual evidence to understand how the specific terms were captured and the appropriate revenue recognition policies applied. We then performed a sample test of sales recognised either side of the year end to substantiate that the appropriate terms of the relevant contracts had been satisfied and that the risks and rewards associated with the contract had passed to the customer. We used external evidence such as shipping documentation or client acceptance where available, to confirm that revenue had been recognised in the appropriate period.</p>

Extract from Deloitte’s auditor’s report on Chemring Group PLC.

The granularity of risk reporting

ISA (UK and Ireland) 700 requires that “in order to be useful to users of the financial statements, the explanations of the matters required to be set out in the auditor’s report by paragraph 19A shall be described ... in a way that enables them to be related directly to the specific circumstances of the audited entity and are not, therefore, generic or abstract matters expressed in standardised language”.

From our Survey some auditor’s reports appear to be more granular than others. An example of a more granular risk disclosure is that provided by KPMG in their auditor’s report on Cable & Wireless Communications plc.

Business transformation

Business transformation (see notes 2.3.5, 2.8, notes 5.1.9, 5.1.10, 5.1.11, 5.1.13, 5.1.15 for accounting policies and note 5.2.4 for critical accounting estimates and judgements and note 5.9 for events after the reporting period).

Risk

In 2014, the asset disposals (Macau and Islands) led to the Group undertaking a business transformation programme that has given rise to significant restructuring and redundancy costs of US \$ 174 million in the continuing Group. These costs have been classified as “exceptional costs” in the Group’s Consolidated income statement.

The Group’s transformation programme is considered to be a significant risk due to the level of judgement required to be applied in establishing the restructuring provisions.

The Group committed to market and seek a buyer for their Monaco Telecom business. This sale was not completed as at 31 March 2014 and was subject to regulatory approval. The Group determined that the uncertainty surrounding the sale process, together with the fact that regulatory approval was a substantive hurdle, prevented classification of the business as held for sale and a discontinued operation at 31 March 2014.

Classification of this business as held for sale and a discontinued operation would lead to significant differences in the presentation of the Group’s results for the year and its gross assets and liabilities. As a result this is one of the key judgement areas of our audit.

Our response

...

Extract from KPMG’s auditor’s report on Cable & Wireless Communications plc

We have evaluated (necessarily somewhat subjectively) the descriptions of the risks in each of the 153 auditor’s reports in our Survey. Our overall conclusion is that 61% of the risks were written in a more granular and less generic matter and 39% were largely generic in nature using more standardised language. In the second year of implementation audit engagement partners may wish to assess whether their disclosures of risk are sufficiently granular.

An analysis of our evaluations by firm, see Table 6, shows that there are differences between the firms – for example KPMG seems to have provided the most granular non-standardised risk disclosures. Excluding KPMG from the analysis would result in an approximate 50/50 split between granular and generic risk descriptions.

TABLE 6 Analysis by audit firm of the granularity of the reporting of risks

	Granular risks that cite specific circumstances	Generic risks written in more standardised language
Deloitte	50%	50%
EY	52%	48%
KPMG	89%	11%
PwC	49%	51%
Other firms	83%	17%
TOTAL	61%	39%

KPMG's experiment in reporting detailed findings with respect to the reported risks

KPMG's auditor's reports in relation to three companies described KPMG's findings with respect to each identified risk. These auditor's reports are each signed by the same engagement partner and relate to the following companies:

- a) Kazakhmys plc;
- b) New World Resources plc; and
- c) Rolls Royce Holdings plc.

For illustration, set out below is an extract from the auditor's report relating to Rolls Royce Holdings plc:

The measurement of revenue and profit in the Civil aerospace business

Refer to page 81 (Key areas of judgement – Long-term aftermarket contracts), page 83 (Significant accounting policies – Revenue recognition) and page 44 (Audit committee report – Financial reporting)

- **The risk** The amount of revenue and profit recognised in a year on the sale of engines and aftermarket services is dependent, inter alia, on the assessment of the percentage of completion of long-term aftermarket contracts and the forecast cost profile of each arrangement. As long-term aftermarket contracts can extend over significant periods and the profitability of these arrangements typically assumes significant life-cycle cost improvement over the term of the contracts, the estimated outturn requires significant judgement to be applied in assessing engine flying hours, time on wing and other operating parameters, the pattern of future maintenance activity and the costs to be incurred. The inherent nature of these estimates means that their continual refinement can have an impact on the profits of the Civil aerospace business that can be significant in an individual financial year. The assessment of the estimated outturn for each arrangement involves detailed calculations using large and complex databases with a significant level of manual intervention.
- **Our response** We tested the controls designed and applied by the Group to provide assurance that the estimates used in assessing revenue and cost profiles are appropriate and that the resulting estimated cumulative profit on such contracts is accurately reflected in the financial statements; these controls operated over both the inputs and the outputs of the calculations. We challenged the appropriateness of these estimates for each programme and assessed whether or not the estimates showed any evidence of management bias. Our challenge was based on our assessment of the historical accuracy of the Group's estimates in previous periods, identification and analysis of changes in assumptions from prior periods and an assessment of the consistency of assumptions across programmes, detailed discussions and assessments of the achievability of the Group's plans to reduce life-cycle costs and an analysis of the impact of these plans on forecast cost profiles taking account of contingencies and analysis of the impact of known technical issues on cost forecasts. Our analysis considered each significant airframe that is powered by the Group's engines and was based on our own experience supplemented by discussions with an aircraft valuation specialist engaged by the Group. We assessed whether the valuer was objective and suitably qualified. We also checked the mathematical accuracy of the revenue and profit for each arrangement and considered the implications of identified errors and changes in estimates.
- **Our findings** Our testing identified weaknesses in the design and operation of controls. In response to this we assessed the effectiveness of the Group's plans for addressing these weaknesses and we increased the scope and depth of our detailed testing and analysis from that originally planned. We found no significant errors in calculation. Overall, our assessment is that the assumptions and resulting estimates (including appropriate contingencies) resulted in mildly cautious profit recognition.

These auditor's reports have created considerable interest from investors and other users of auditor's reports not only in the UK but also internationally. Tony Cates the head of audit at KPMG UK LLP explains some of the reasoning behind KPMG's experiment as follows:

But what next?

The challenge is this. As it stands a new audit report tells shareholders the key risks and the auditor's response to them - what the auditor did to address them. In other words, what rocks did the auditor check under and how did he go about turning them over? However, it is not telling shareholders what the auditor found when he looked under those rocks. It does not say, for example, how acceptable the policies, estimates or disclosures were.

So we asked ourselves a simple question. Why not?

If we truly want audit to make a difference, not only do we have to ask these challenging questions, but offer bold answers – daring to think differently? So we have put it to the test by issuing a small number of audit reports that extend the new audit report, beyond the minimum required, by also setting out what we found. With the agreement of our clients, Rolls-Royce Holdings plc and New World Resources ...the audit reports to their shareholders do just that. So whilst our KPMG reports normally set out under each audit issue, “the risk” and “our response”, on these occasions we have added “our findings”.

So what did we learn from the experience?

Well unsurprisingly, distilling all the professional judgments that go into an audit into a few words was not always straightforward. In particular, a binary finding – eg, that an estimate is acceptable – would be of little value; after all, that the estimates are acceptable is inherent in an overall clean opinion. Instead what is required is graduated findings that say whereabouts in a range matters sit. And explaining an accounting estimate was simpler than the relative merits of an accounting treatment.

Our experience would, I trust, provide valuable insight for the Financial Reporting Council (FRC) if they choose to require this approach across the profession. We'd need to be careful however, that any auditing standard would not “standardise” the report – which would be a step back to the old days of boiler-plate – but provides a framework to enable comparison between companies. However, I should not seek absolute “grading” consistency, which would be difficult to achieve: there is greater value in the application of professional judgment than in the result of a mechanical process.

However, we didn't put this innovation to the test primarily for the “practical tips”. Rather I want this innovative audit report to kick-start debate: by showing investors, audit committees, companies and the audit profession as a whole, what could be achieved.

The FRC encourages experimentation by auditors and will be particularly interested in the reaction of investors and users to auditor's reports of this ilk. However, care needs to be taken with the inclusion of such findings in an auditor's report so as not to inappropriately include discrete opinions on separate elements of the financial statements.

Reporting of materiality

Introduction

ISA (UK and Ireland) 700 establishes a general requirement for the auditor's report to explain how the auditor applied the concept of materiality in both planning and performing the audit. Its only detailed requirement is that the explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole.

All of the auditor's reports in our Survey met these two requirements. However, there is quite a wide range of further informational content with respect to materiality as between individual auditor's reports.

ISA (UK and Ireland) 700 paragraph A13B suggests five further matters that the explanation might include. Table 7 illustrates that the take up of these matters varies quite widely:

TABLE 7 Matters that ISA (UK and Ireland) 700 suggests might be included in an explanation of materiality

Matter that might be included	Overview of take up in auditor's reports
Materiality level or levels for those classes of transactions, account balances or disclosures where such materiality levels are lower than materiality for the financial statements as a whole	5 of our sample of 153 included discussion of different levels of materiality
Performance materiality ⁵	With some exceptions, the disclosure of performance materiality was restricted to auditor's reports from EY
Any significant revisions of materiality thresholds that were made as the audit progressed	No examples found
The threshold used for reporting unadjusted differences to the Audit Committee	There is widespread disclosure of this threshold
Significant qualitative considerations relating to the auditor's evaluation of materiality	No examples found

Two further matters not cited as examples of further matters in ISA (UK and Ireland) 700 are:

- a) the benchmark used by the auditor in determining materiality for the financial statements as a whole; and
- b) the percentage applied to the benchmark to determine materiality for the financial statements as a whole.

⁵ Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

The benchmark used by the auditor in determining materiality for the financial statements as a whole is stated in 148 of the 153 (97%) auditor's reports in our Survey. Of these, 128 (84%) of the auditor's reports described the percentage that was applied to the benchmark in order to determine materiality for the financial statements as a whole. 37 of the auditor's reports disclosed the reasoning behind the choice of the benchmark. Approximately 50% of the auditor's reports which disclosed the auditor's reasoning were issued by Deloitte.

The most common threshold used by auditors in the reports surveyed was 5% of either profit before tax or an adjusted measure of profit before tax. 79% of the auditor's reports surveyed indicated that materiality for the financial statements as a whole was based on either profit before tax or a proxy measure for profit before tax.

The wide range of materiality benchmarks used

Our Survey has revealed a wide range of benchmarks being used by auditors in their application of the concept of materiality. The Survey has also revealed that when similar benchmarks are used there is quite a wide range of percentages applied to those benchmarks. It is difficult to understand the rationale for these ranges absent explanations in the auditor's reports. However, the ranges do reveal that a significant degree of judgment appears to be used by auditors in their determination of the materiality benchmarks.

The Auditing Standards do not stipulate criteria for the determination of materiality benchmarks. They do however set out, as guidance, the following factors that may affect the identification of an appropriate benchmark:

- a) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- b) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- c) The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- d) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- e) The relative volatility of the benchmark.

The Auditing Standards also recognise that the use of normalized profits as a benchmark may be appropriate.

The range of benchmarks used is depicted graphically in Table 8.

TABLE 8 Range of materiality benchmarks used

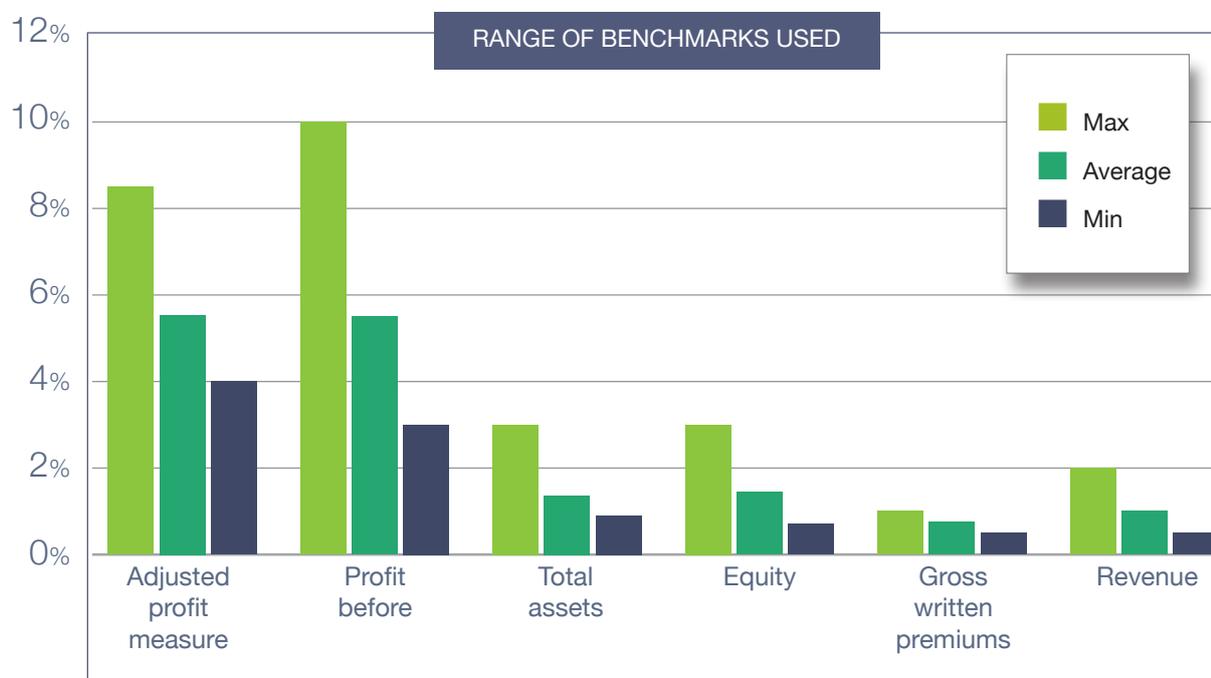


Table 9 shows the range of benchmarks used analysed by audit firm.

TABLE 9 Range of materiality benchmarks used analysed by audit firm

MATERIALITY BENCHMARKS	Deloitte	EY	KPMG	PWC	Others	Total
Adjusted profit measure	25	9	16	25	1	76
Profit before tax	9	7	15	14	1	46
Revenue		1	3	1	2	7
Total assets	2	1	1	3	1	8
Equity	4	2				6
Gross written premiums			2			2
Non-current assets	1					1
Total expenditure					1	1
Not disclosed	1	1		4		6
Grand Total	42	21	37	47	6	153

There is quite a wide variety of proxy measures of profit before tax including, for example:

5% of profit before taxation and non-recurring exceptional items

Extract from EY's auditor's report on Computacenter plc

4.1% of pre-tax profit before special items and remeasurements, and below 1% of equity. Pre-tax profit is normalised for the materiality calculation to exclude impairments, remeasurements and other one off items that are audited separately and would, if included, significantly distort the materiality calculation year on year.

Extract from Deloitte's auditor's report on Anglo American plc

Overall materiality was determined through taking 5% of profit before taxation adjusted for own credit, the provision for payment protection insurance redress payments and claims management costs, the provision for interest rate hedging products redress and claims management costs, goodwill impairment and costs to achieve Transform. The removal of these items mitigates undue volatility in determining our materiality.

Extract from PwC's auditor's report on Barclays plc

The materiality for the financial statements as a whole was set at £13.0 million. This has been determined with reference to a benchmark of Group profit before taxation which we consider to be one of the principal considerations for members of the company in assessing financial performance of the Group. Materiality represents 8.5% of group profit before taxation adjusted for the rationalisation costs set out in Note 4 (Non-recurring operating items and non-operating items) and 11.8% of the Group profit before taxation as disclosed on the face of the income statement.

Extract from KPMG's auditor's report on Carillion plc

One investor (Citi Research) has commented that "we are interested to see auditors relying for their own calculations on a number, which is not defined in IFRS, which often includes adjustments other than truly 'exceptional' ones and on which historically auditors have been unwilling to pass any judgment". Auditing Standards do not require materiality to be based on an IFRS metric and it will be interesting to see the reactions of other investors to the wide range of benchmarks being used by auditors.

Magnitude of unadjusted differences being reported to the Audit Committee

There is widespread disclosure of the threshold used for reporting unadjusted differences to the Audit Committee. Two examples of such disclosures are:

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £0.4 million, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

Extract from Deloitte's auditor's report on Taylor Wimpey plc (Note £0.4 million is 2% of the planning materiality of £20 million)

We agreed with the audit committee to report to it the following misstatements that we identified through our audit: (i) all material corrected misstatements; (ii) uncorrected misstatements with a value in excess of £4 million for income statement items (or £8 million for balance sheet reclassifications); and (iii) other misstatements below that threshold that we believe warranted reporting on qualitative grounds.

Extract from KPMG's auditor's report on Rolls Royce plc (Note £4 million is 4.7% of the materiality for the Group financial statements as a whole of £86 million)

For our sample of 153 companies, unadjusted differences being reported to Audit Committees averaged 4% of the materiality level for the financial statements as a whole. As can be seen from Table 10, three of the largest four audit firms indicated that on average they reported unadjusted differences of 5% of materiality for the financial statements as a whole. The fourth firm (Deloitte) on average reported differences of 2% of materiality for the financial statements as a whole.

TABLE 10 Reporting of unadjusted differences as a percentage of materiality for the financial statements analysed by audit firm

	Deloitte	EY	KPMG	PwC	Other	All Firms Together
Range of Materiality	5%-2%	7%-2%	10%-2%	10%-3%	5%-2%	
Mean of Materiality	2%	5%	5%	5%	3%	4%

Performance Materiality

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

With respect to the four largest firms, with the exception of auditor's reports for two companies, the reporting of Performance Materiality is restricted to auditor's reports from EY. Table 11 illustrates the range of measures of performance materiality used.

TABLE 11 Range of measures of performance materiality used

Auditor	Performance Materiality set at 50% of planning materiality	Performance Materiality set at 70% of planning materiality	Performance Materiality set at 75% of planning materiality	Total
Deloitte	-	2	-	2
EY	10	-	9	19
KPMG	-	-	-	-
PwC	-	-	-	-
Other	-	-	4	4

Two extracts from EY auditor's reports that address performance materiality are:

On the basis of our risk assessments, together with our assessment of the overall control environment, our judgement is that performance materiality was 75% [2012: 75%] of our materiality, namely £11.25 million [2012: £ 11.25 million]. Our objective in adopting this approach was to ensure that uncorrected and undetected audit differences in all accounts did not exceed our planning materiality level.

Extract from EY's auditor's report on AMEC plc

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement is that performance materiality for the Group should be 50% of materiality, namely £3.0 million. Our approach is designed to have a reasonable probability of ensuring that the total of uncorrected and undetected audit differences does not exceed our materiality of £6.1 million for the financial statements as a whole.

Extract from EY's auditor's report on Enterprise Inns plc

An example of a discussion relating to Performance Materiality from Deloitte appears in its auditor's report on Vodafone.

On the basis of our risk assessments, together with our assessment of the Group's overall control environment, our judgement is that overall performance materiality for the Group should be 70% of planning materiality, namely £350 million. Our objective in adopting this approach is to ensure that total detected and undetected audit differences do not exceed our planning materiality of £500 million for the financial statements as a whole.

Extract from Deloitte's auditor's report on Vodafone plc

An example of a discussion relating to Performance Materiality from BDO appears in its auditor's report on Randgold Resources Limited.

On the basis of our risk assessment, together with our assessment of the group's control environment, our judgment is that performance materiality for the financial statements should be 75% of materiality, which equates to US\$ 22.7 million for the financial statements as a whole. Our objective in adopting this approach is to ensure that total detected and undetected audit differences do not exceed our materiality of US\$ 30.2 million for the financial statements as a whole.

Extract from BDO's auditor's report on Randgold Resources Limited

In a very few auditor's reports there is discussion of the concept of performance materiality without reference to the specific measurement of performance materiality that the auditor had used. An example of this can be found in Deloitte's auditor's report on British Sky Broadcasting Group plc.

We also determine a level of performance materiality which we use to determine the extent of testing needed to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

Extract from Deloitte's auditor's report on British Sky Broadcasting Group plc

Describing the scope of the audit

Ordering of paragraph 19A disclosures

Paragraph 19A of ISA (UK and Ireland) 700 requires disclosure of:

- (a) Assessed risks of material misstatement that were identified by the auditor...;
- (b) An explanation of how the auditor applied the concept of materiality in planning and performing the audit...; and
- (c) Provide an overview of the scope of the audit including an explanation of how such scope addressed the assessed risks of material misstatement disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b).

ISA (UK and Ireland) 700 does not explicitly require these disclosures to be made in the same order as in paragraph 19A. However, the FRC had this ordering in mind as it would seem to be the logical order to facilitate the discussion of the scope – explaining how the scope addressed each risk and was influenced by the auditor's application of materiality. However, not all engagement partners followed this ordering, with a number of them beginning with the scope of the audit and describing this in a broadly stand-alone manner rather than in relation to their risk and materiality assessments.

In part, we attribute this to the widespread adoption of tabular presentations linking the assessed risks of material misstatement with an explanation of how the audit scope addressed the risk (see page 46 for discussion of the tabular approach).

A summary of the ordering of paragraphs that we found in the Survey is set out in Table 12.

TABLE 12 Ordering of paragraph 19A disclosures

Order of Paragraph 19A Disclosures	Number in sample	% of sample	Predominant audit firm(s) using this approach
Risk/Materiality/Scope	67	44%	Deloitte/EY
Risk/Materiality & Scope	35	23%	KPMG
Materiality/Scope/Risk	47	30%	PwC
Materiality/Scope & Risk	1	1%	Deloitte
Scope/Risk/Materiality	1	1%	Deloitte
Scope/Materiality/Risk	2	1%	Grant Thornton
Total	153	100%	

The approach adopted in many of the EY auditor's reports is perhaps closest to what the FRC envisaged when drafting the requirements. The example below is from the auditor's report for Smith & Nephew plc:

An overview of the scope of our audit

Following our assessment of the risk of material misstatement to the Group financial statements, we selected 11 components which represent the principal business units within the Group's two reportable segments and account for 70% of the Group's total assets, 65% of Group revenue and 81% of the Group's profit before tax. Two of these components were subject to a full audit, whilst the remaining nine were subject to a partial audit where the extent of audit work was based on our assessment of the risks of material misstatement and of the materiality of the Group's business operations at those locations. They were also selected to provide an appropriate basis for undertaking audit work to address the risks of material misstatement identified above. For the remaining components, we performed other procedures to test or assess that there were no significant risks of material misstatement in these components in relation to the Group financial statements.

The audit work at the 11 components was executed at levels of materiality applicable to each individual entity which were lower than group materiality.

The Group audit team continued to follow a programme of planned visits that has been designed to ensure that the Senior Statutory Auditor or his designate visits each of the locations where the Group audit scope was focused at least once a year. For all full scope entities, in addition to the location visit, the Group audit team reviewed key working papers, participated in the component team's planning including the component team's discussion of fraud and error. The Group audit team visited 9 locations in total over the course of the current year audit.

Our response to the risks identified above was as follows:

-

Recognition and measurement of provisions for legal disputes - ...

Extract from EY's auditor's report on Smith & Nephew plc

Assessment of how well the auditor's description of the scope of audit addresses the assessed risks of material misstatement and the auditor's application of materiality.

We assessed how well the descriptions of the scope of the audit in the auditor's report addressed the assessed risks of material misstatement and the auditor's application of materiality. Although our individual assessments are necessarily subjective we believe that our overall findings in this regard suggest some room for greater attention to this aspect of the requirements. We found that 56% of reports provided a comprehensive explanation of how the scope of audit addressed the assessed risks of material misstatement and the auditor's application of materiality. A further 24%, whilst adequate, seemed to meet the requirement more in form than in substance. We assessed the remaining 20% as not fully meeting the spirit of the requirement.

The primary reasons for assessing auditor's reports as less than "good" in this respect were:

- Describing the scope of the audit before the discussion of risks and materiality and providing a description that is rather detached from the discussion of risks and materiality.
- An apparently undue focus on standard risks.

However, in a first year of experimentation, in aggregate this would seem to be a reasonable outcome.

Measures used in describing the scope of the audit

Table 13 shows by audit firm the various measures used in describing the scope of the audit.

TABLE 13 Analysis of measures used in describing the scope of the audit

Firm	Revenue Coverage	Total Asset Coverage	Profit before tax or other profit measures	Other measures	Total audits by firm in sample
Deloitte	30	25	25	5	42
EY	12	12	17	2	21
KPMG	30	33	31	5	37
PwC	14	4	23	2	47
Other	1	1	1	-	6
Total	87	75	97	14	153
Total as a % of Sample	57%	49%	63%	9%	

Table 13 demonstrates that in many auditor's reports a number of different measures are described. The following example to illustrate this point is taken from KPMG's auditor's report on Rolls Royce plc.

<p>In order to gain appropriate audit coverage of the risks described above and of each individually significant reporting component:</p> <p>(a) audits for Group reporting purposes were carried out at 13 key reporting components located in the following countries: United Kingdom (9 key reporting components), USA (1), Germany (2) and Norway (1). In addition, audits for Group reporting purposes were performed at a further 20 reporting components. Together these covered 90 per cent of revenue, 87 per cent underlying profit before taxation and 85 per cent of total assets; and</p> <p>(b) specified reporting procedures were carried out over key risk areas at a further 12 reporting components, none of which are considered to be key.</p> <p>In total our procedures covered 98 per cent of revenue, 99 per cent of underlying profit before taxation and 94 per cent of total assets.</p> <p>...</p> <p>Extract from KPMG's auditor's report on Rolls Royce plc</p>

A further variation, which also provides comparative information, is provided in EY's auditor's report on the Weir Group:

An overview of the scope of our audit

Following our assessment of the risk of material misstatement to the Group financial statements, we selected twenty one (2012: nineteen) locations which represent the principal business units within the Group's three reportable segments and account for 69% (2012: 70%) of the revenue, 73% (2012: 77%) of the profit before tax from continuing operations and 75% (2012: 72%) of the net assets. Three (2012; two) of these were subject to a full audit, whilst the remaining eighteen (2012: seventeen) were subject to a partial audit where the extent of audit work was based on our assessment of the risks of material misstatement and of the materiality of the Group's business operations at those locations. The audit work at the twenty one locations was executed at levels of materiality applicable to each individual entity which were lower than Group materiality.

In addition, certain central reporting entities and Group functions including those covering treasury, taxation, pensions and the Parent Company were subject to a full scope audit. For the remaining locations, we performed other procedures to confirm there were no significant risks of material misstatement in the Group financial statements.

The Group audit team continued to follow a programme of planned visits and video-conferencing that has been designed to ensure that the Senior Statutory Auditor or his designate visits those locations with greatest exposure to the risks of material misstatements noted above.

Our response to the risks of material misstatement identified above included the following procedures:

...

Extract from EY's auditor's report on The Weir Group plc

An example of an auditor's report where the scope of the audit appears to be described in rather more generic terms is provided by that of PwC on Standard Life plc:

The group is reported in five reportable segments being UK and Europe, Standard Life Investment, Canada, Asia and Emerging Markets and Other. These segments are disaggregated into reporting units. The Group's financial statements are a consolidation of these reporting units.

In establishing the overall approach to the Group audit, we determined the type of work that needed to be performed at the reporting units by us, as the group engagement team, or component auditors within PricewaterhouseCoopers (PwC) and from other PricewaterhouseCoopers network firms operating under our instruction. Where the work was performed by component auditors, we determined the level of involvement we needed to have in the audit work at those reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the Group financial statements as a whole.

Accordingly, we identified 10 of the Group's reporting units which, in our view, required an audit of their complete financial information, either due to their size and/or their risk characteristics. These focussed on the material reporting units within the UK and Europe, SLI and Canada reportable segments. In addition, specific audit procedures on certain balances and transactions were performed at a further 10 reporting units within the Group across all reportable segments. Additional procedures were also performed at the Group level over the group consolidation and other reporting packs in order to gain further audit evidence. Overall we concluded that this gave us the evidence we needed for our opinion on the Group financial statements as a whole.

Extract from PwC's auditor's report on Standard Life plc

KPMG's experiment with more detailed explanation of the scoping process in the auditor's report of Standard Chartered

KPMG also field tested (in the auditor's reports of HSBC and Standard Chartered) a model for reporting the scope of the audit which included additional explanatory narrative setting out how the engagement partner made his risk assessment and how it affected the scope of the audit and determined the key risks. An extract from the auditor's report of Standard Chartered is set out below which illustrates this additional narrative:

1) Opinions and conclusions arising from our audit

Our opinion on the financial statements is unmodified.

We have audited the financial statements of Standard Chartered PLC (the Group) for the year ended 31 December 2013 set out on pages 229 to 311. In our opinion:

- The financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2013 and of the Group's profit for the year then ended
- The group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union (EU)
- The parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006
- The financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation

2) Our assessment of the risks of material misstatement

The starting point for our audit was a consideration of the inherent risks to the Group's business model and how these have been mitigated. This included understanding the strength of the Group's capital and liquidity position, the diversification of its assets, the flexibility and tenor of its balance sheet and the management of its cost base. We assessed and challenged the inherent risks with reference to:

- Independent economic forecasts and commentary
- The perspectives of our in-country audit teams on their local economies and banking industries
- The views of our specialists in a number of areas including bank regulation, IT, tax and financial crime prevention
- The views of the Prudential Regulatory Authority
- The significant changes taking place in banking regulation, both in the UK and in the other jurisdictions in which the Group operates
- Checking for consistency between (among others) the Group's budgets, regular forecasts, stress testing, reporting to the Audit, Board Risk and Group Risk Committees and the many discussions we have with senior management in different countries

We also considered the Group's control environment and in particular whether its systems were processing transactions completely and faithfully, and included appropriate controls designed to prevent fraud. Our work included testing the key controls over the processing of transactions and the key inter-system, bank and custodial reconciliations as well as trade confirmations. In addition we sought to apply industry lessons learned from recent dealing room issues at other banks in our testing of controls.

These assessments enabled us to form a judgment on going concern and also highlighted the key areas of financial statement risk on which our audit has focused. By looking at both broad risk themes across the Group and particular concerns in specific geographies and businesses, we were able to calibrate our work to financial statement risk more precisely. In particular we identified the following issues: economic difficulties in India caused some stress in the Group's wholesale portfolio; high consumer debt levels plus an economic slowdown in South Korea caused some stress in the Group's consumer portfolio; more generally these factors in South Korea continued to depress profitability there; and, while the UAE economy is recovering and property prices are rising, risk in the portfolio does remain from the debt overhang that arose in the financial crisis.

Having addressed the going concern assumption and whether the Group's database of transactions was a sufficient underlying basis for the accounts, the risks of material misstatement lay in decisions over loan and goodwill impairments and the valuation of financial instruments. This is because they require significant judgment in assessing subjective and uncertain estimates. As described on pages 158 to 159 these are also the areas that have been focused on by the Group's Audit Committee. In forming our unmodified opinion on the financial statements, we undertook the following principal procedures on each of these areas as follows.

Auditor's reports that make reference to the use of auditor's experts or specialists

Auditing Standards refer to auditors using both experts and specialists. An auditor's expert is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either internal or external to the auditor's firm. By contrast, a specialist is a member of the engagement team with expertise in a specialised area of accounting or auditing, including for example taxation.

ISA (UK and Ireland) 620 "Using the Work of an Auditor's Expert" prohibits an auditor from referring to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless the auditor is required by law or regulation to do so. The reasoning for this is that, in the context of a binary opinion, such reference may inappropriately imply a reduction in the auditor's responsibility for the opinion.

The development of the extended auditor's report begs the question as to whether such a prohibition continues to be appropriate or whether it would unduly fetter an auditor's ability to clearly describe the way in which the audit was scoped.

72 (47%) of the auditor's reports surveyed make reference to the use of auditor's experts or specialists. This practice is spread across all of the audit firms and is not restricted to the auditor's reports of one or more particular firms.

The experts or specialists referred to in the auditor's reports in our Survey are summarised in Table 14.

TABLE 14 Analysis by audit firm of auditor's reports that refer to auditor's experts or specialists

	Valuation	Taxation	Actuarial	Legal	Other	No. of Companies
Deloitte	7	14	4	3	8	24
EY	7	2	2	1	4	11
KPMG	13	9	10	-	7	24
PwC	2	4	-	3	1	10
Others	2	1	1	1	-	3
Total	31	30	17	8	20	72

In the context of an extended auditor's report, referring to auditor's experts (and specialists) seems more appropriate than making reference in a report containing a binary opinion. This is because, by its very nature, the extended auditor's report can explain the context within which the auditor's expert/specialist was used.

Auditor's reports that make reference to the use of component auditors⁶

ISA (UK and Ireland) 600 “Special Considerations – Audits of Group Financial Statements (including the work of Component Auditors) proscribes the audit engagement partner from referring to the work of a component auditor in an unmodified auditor’s report. The reasoning for this is that, in the context of a binary opinion, such reference may inappropriately imply a reduction in the audit engagement partner’s responsibility for the audit opinion.

The development of the extended auditor’s report also begs the question as to whether such a prohibition continues to be appropriate or whether it would unduly fetter an auditor’s ability to clearly describe the way in which the audit was scoped.

84 (55%) of the auditor’s reports in our Survey make reference to the involvement of component auditors. As can be seen from Table 15 this practice is spread across all the audit firms and is not restricted to the auditor’s reports of one or more particular firms.

TABLE 15 Analysis by audit firm of auditor’s reports that refer to component auditors

	Auditor’s reports	% of total of firm’s reports in Survey
Deloitte	14	33
EY	2	10
KPMG	28	76
PwC	38	81
Others	2	33
Total	84	55

In the context of an extended auditor’s report, referring to component auditors seems more appropriate than making reference in a report containing a binary opinion. This is because, by its very nature, the extended auditor’s report can explain the context in which the component auditor was used.

⁶ A component is an entity or business activity for which group or component management prepares financial information for inclusion in the group financial statements. A component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Going concern disclosures in auditor's reports

Separate Going Concern Section of the Auditor's Report

As can be seen from Appendix 3, ISA (UK and Ireland) 700 requires the auditor to report only by exception with respect to the requirements of the Listing Rules regarding going concern.

However two of the larger audit firms (Deloitte and PwC) include a discrete section in their auditor's reports on Going Concern which goes further than the reporting by exception that is currently required by Auditing Standards. As a result, of our sample of 153 auditor's reports, 89 (58%) include a Going Concern section and this is illustrated in the Bodycote auditor's report in Appendix 4.

The following are further examples of such discrete sections of auditor's reports.

Going concern

As required by the Listing Rules we have reviewed the directors' statement on page 71 that the group is a going concern. We confirm that:

- we have concluded that the directors' use of the going concern basis of accounting in the preparation statements is appropriate.
- we have not identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.

Extract from Deloitte's auditor's report on Kingfisher plc

This section of the auditor's report is quite prominent, being the second section of the auditor's report immediately following the opinion on the financial statements.

Going Concern

Under the Listing Rules we are required to review the Director's statement, set out on page 29, in relation to going concern. We have nothing to report having performed our review.

As noted in the Statement of Directors' Responsibilities, set out on page 54, the Directors have concluded that it is appropriate to prepare the Group's financial statements, using the going concern basis of accounting. The going concern basis presumes that the Group has adequate resources to remain in operation, and that the Directors intend it to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the Directors' use of the going concern basis is appropriate.

However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's ability to continue as a going concern.

Extract from PwC's auditor's report on Marston's plc

This section of the auditor's report, being located immediately following the disclosures required by paragraph 19A of ISA (UK and Ireland) 700, is not quite as prominent in the auditor's report as in the Deloitte example above.

Example of more innovative going concern auditor's report content

In almost all instances where there is a going concern section of the auditor's report the wording is similar to the two examples above. However, we found one instance of a more innovative report in the auditor's report of PwC on Lloyds Banking Group plc.

Going concern

Under the Listing Rules we are required to review the directors' statement, set out on page 74, in relation to going concern. We have nothing to report having performed our review.

As noted in the directors' statement, the directors have concluded that it is appropriate to prepare the Group's and Parent Company's financial statements using the going concern basis of accounting. The going concern basis presumes that the Group and Parent Company have adequate resources to remain in operation, and that the directors intend them to do so, for at least one year from the date the financial statements were signed. In drawing this conclusion, the directors have considered:

- the regulatory capital position of the Group which is critical to the market maintaining confidence in the Group's ability to absorb losses that it may occur in a market stress; and
- the funding and liquidity position of the Group to be able to meet its liabilities as they fall due, including in a market stress.

This is an area of focus of our audit and we have concluded that the directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's and the Parent Company's ability to continue as a going concern. In drawing our conclusion, we critically assessed the going concern assessment undertaken by management and approved by the Board of Directors. As part of our assessment we have:

- critically assessed and challenged the appropriateness of the stress scenarios used and their impact on the Group's capital and liquidity position;
- understood and assessed key economic and other assumptions used in both the capital and liquidity plan and the Group's five year operating plan; and
- substantiated the Group's unencumbered collateral position and potential to access central bank liquidity facilities.

Extract from PwC's auditor's report on Lloyds Banking Group plc

In September 2014 the FRC updated the Code and Auditing Standards in respect of going concern and risk management; distinguishing between the going concern basis of accounting and a longer term assessment of viability. Accordingly, we might expect further auditor reporting innovation in that regard.

Location of the auditor's opinion

In its recent revisions to ISA (UK and Ireland) 700 the FRC did not make any changes relating to the positioning of the auditor's opinion on the financial statements within the auditor's report. In fact ISA (UK and Ireland) 700 does not mandate an ordering for the auditor's report. However, as can be seen from Appendix 3 the FRC in the non-mandatory illustrations that it provides takes a linear approach to the structure of the auditor's report placing the auditor's opinion after the introductory paragraph and paragraphs describing the respective responsibilities of the directors and the auditor and the scope of the audit of financial statements.

Section 495(2) of the Companies Act 2006 requires the auditor's report to include "an introduction identifying the annual accounts that are the subject of the audit and the financial reporting framework that has been applied in their preparation".

Perhaps influenced by the proposals to improve auditor's reports (recently approved and issued) by the International Auditing and Assurance Standards Board (IAASB) a number of auditors have voluntarily decided to reconfigure their audit reports such that the audit opinion is the first item in the report. A summary of the location of the audit opinion in the auditor's reports we surveyed is set out in Table 16.

TABLE 16 Analysis of the location of the auditor's opinion within the auditor's report

Location of Opinion	Number	%	Firms Following this approach
Opinion is located first with no introduction	93	61%	PwC 48% Deloitte 46% BDO 2% E & Y 2% haysmacintyre 1% KPMG 1%
Opinion is located first following a brief introduction	41	27%	KPMG 88% EY 7% PwC 5%
Opinion presented following scope of the audit and before the paragraph 19A disclosures i.e. in accordance with FRC template	16	10%	EY 94% BDO 6%
Opinion presented at the end section of the audit report which provides the opinion on the financial statements	3	2%	Grant Thornton 67% EY 33%
Total	153	100%	

Three of the four largest audit firms (Deloitte, KPMG and PwC) have all reconfigured their auditor's reports to place their opinion on the financial statements as the first item in the report. We understand that their reasoning for doing this is a wish to place the most important information at the beginning of the auditor's report. For many of these firms this change needs to be seen in conjunction with other changes they have made to reconfigure their auditor's reports, including moving sections that include standard language (ie content that does not change from report to report) to the end of the auditor's report; and in the case of KPMG out of the auditor's report altogether and on to a web-site cross-referred to in the auditor's report.

The Companies Act has a requirement for an auditor's report to have an "introductory paragraph" identifying the accounts subject to audit and the financial reporting framework applied in their preparation. As can be seen from Table 16, 41 of the 133 reports where the opinion is located first do have a brief introduction (primarily these are the auditor's reports from KPMG). The others, in the same or a later paragraph, do make clear which accounts are subject to audit and which financial reporting framework was applied in their preparation. Although such a paragraph may not be the "first" paragraph such a paragraph can, nevertheless, be considered to be introductory as it "provides an introduction".

We understand that the firms who have not changed the placement of the opinion have a concern that if they do so the remainder of the auditor's report may not be read.

The use of standard language in auditor's reports

Description of the Generic Scope of an Audit

Paragraph 16 of ISA (UK and Ireland) 700 requires the auditor's report to include a description of the generic scope of an audit by either:

- (a) Cross referring to the applicable version of a "Statement of the Scope of an Audit" that is maintained on the FRC's web-site; or
- (b) Cross referring to a "Statement of the Scope of an Audit" that is included elsewhere within the Annual Report; or
- (c) Including verbatim within the report the following text:

"An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the [describe nature of entity] circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by [describe those charged with governance]; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the [describe the Annual Report] to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report."

Prior to the introduction of the Extended Auditor's Report three of the six largest audit firms (BDO, Grant Thornton and KPMG) adopted option (a) above and cross-referred to the version of the Statement of the Scope of an Audit maintained on the FRC's web-site. The other three largest firms (Deloitte, EY and PwC) opted for option (c). The introduction of the extended auditor's report did not give rise to any changes in the options chosen by the six largest audit firms.

Liability limitation wording included in auditor's reports

In conjunction with its adoption of the extended auditor's report, KPMG removed the so-called "Bannerman" wording from the main body of the auditor's report replacing it with an explanation of its responsibilities published on its website. The Bannerman wording is standard wording which is often included in auditor's reports with the intention of asserting that the legal liability of the auditor is restricted to the Company and its shareholders as a body. Its inclusion is recommended by the professional accountancy bodies and is not a requirement of ISA (UK and Ireland) 700.

The Bannerman wording varies between firms. An example is as follows:

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

KPMG in its reports has combined a description of the scope of the audit and its responsibilities into a final concluding paragraph as follows:

Scope of report and responsibilities

As explained more fully in the Directors' Responsibilities Statement set out on page xx, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate

This report is made solely to the Company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2013a, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

Addition to standard language to refer to compliance with Quality Control Standards

Although there is a general trend to reduce the use of standard language in auditor's reports Deloitte, in some of its auditor's reports, has added the following wording in the paragraph describing the respective responsibilities of directors and auditors.

We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team, strategically focused second partner reviews and independent partner reviews.

The use of diagrams and graphs

Almost without exception the firms have taken the opportunity of issuing extended auditor's reports to improve their presentation of auditor's reports more generally.

Use of tabular presentations

A particularly notable technique has been the use of a tabular presentation linking the assessed risks of material misstatement and the explanation of how the audit scope addressed the risks.

Examples of the headings used in such tables are set out in Table 17.

TABLE 17 Examples of the headings used in tabular presentations in auditor's reports

Risk	How the scope of our audit responded to the risk	Deloitte
The risk	Our response	KPMG
Risk	The procedures to address these audit risks included, amongst others, those listed below	KPMG
Risk	Our response	haysmacintyre
Area of focus	How the scope of our audit addressed the area of focus	PwC

Providing a road map to other relevant sections of the Annual Report

Some of the auditor's reports (typically those from KPMG engagement partners) include within these tables relevant cross references to, for example, the financial statements, the Audit Committee Report and the Financial Review. An example of this from the Auditor's Report on Ted Baker plc for the 52 weeks ended 25th January 2014 is illustrated below.

Valuation of retail fixed assets

Refer to page 15 (Audit Committee statement), page 57 (accounting policy note) and page 66 (financial disclosures).

The risk: The Group has invested a significant amount of capital outside the UK in its retail store portfolio. Given the relative immaturity of the brand outside the UK, the payback period is typically longer than for UK stores and it is not uncommon for new stores in overseas territories - as is anticipated in the original business case - to make losses in their start up phase. The level of judgment involved in assessing impairment indicators on recently opened retail stores in foreign markets is one of the key judgemental areas that our audit is concentrated on.

Our response: Our audit procedures included, among others, challenging the Directors on the evidence on which they based their assessment as to when an impairment indicator exists for loss making stores and therefore a need for impairment testing arises. This included comparing the performance of retail stores to the original business case, comparing relative performance of stores within each region and considering whether the Directors' assessment was in line with our overall understanding of the maturity of the brand in each location. We have also considered the adequacy of the Group's disclosures in respect of impairment of retail fixed assets.

Use of more elaborate diagrams within auditor's reports

In addition to the use of tabular presentations our sample of auditor's reports included six auditor's reports which include more elaborate diagrams. One example of these is Bodycote plc whose auditor's report is reproduced at Appendix 4.

Another example of innovation was in PwC's report on Cairn Energy plc which included the following table illustrating what type of risk applied:

Independent Auditors' Report to the Members of Cairn Energy PLC
Continued

This work gave us coverage of 93% over the Group total assets at 31 December 2013 and, together with the procedures performed at a Group level, including confirming bank balances and goodwill impairment testing, gave us the evidence we needed to form our opinion on the Group financial statements.

Areas of particular audit focus
In preparing the financial statements, the directors made a number of subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We primarily focused our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

In our audit, we tested and examined information, using sampling and other auditing techniques, to the extent we considered necessary to provide a reasonable basis for us to draw conclusions. We obtained audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

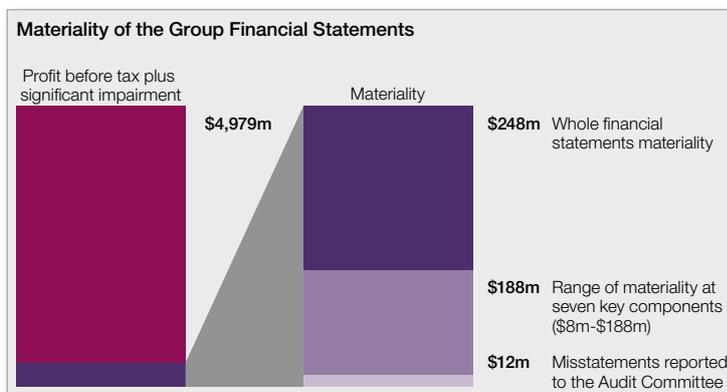
We considered the following risks, arising from risk of fraud, error and/or judgement, to be those that required particular focus in the current year. This is not a complete list of all risks or areas of focus identified by our audit. We discussed these areas of focus with the Audit Committee. Their report on those matters that they considered to be significant issues in relation to the financial statements is set out on pages 78 to 80.

Risks	Nature of risk		
	Fraud	Error	Judgement
Impairment of exploration/development costs and goodwill	X	X	X
Tax judgements		X	X
Management override of controls	X		

The scope of our audit addressed these risks as follows:

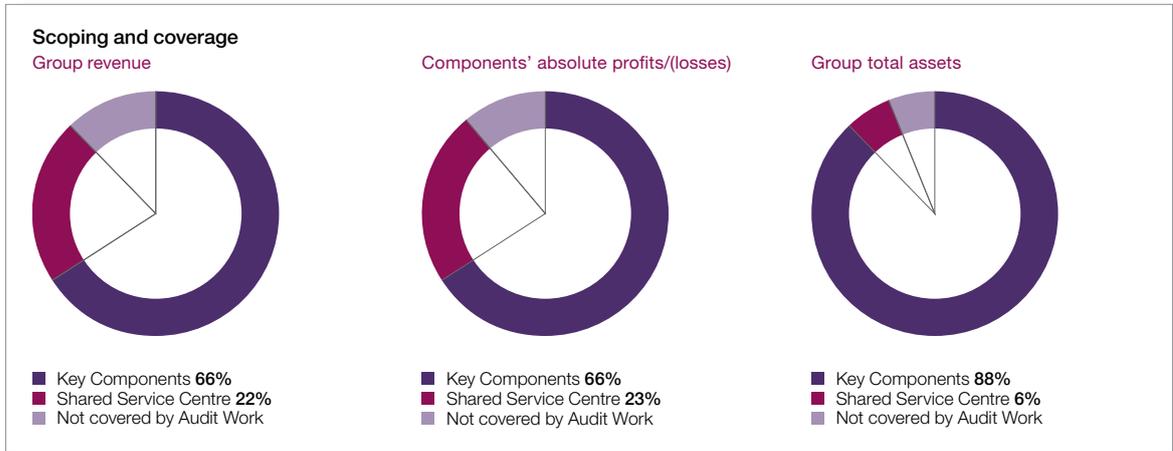
Area of focus	How the scope of our audit addressed the area of focus
Impairment of capitalised exploration and development costs and goodwill We focused on this area due to the significant value attached to goodwill and	We tested management's impairment review of goodwill and capitalised exploration and development costs. Specific work included:

However, perhaps the most extensive use of diagrams in our sample was in KPMG's auditor's report on Astra Zeneca which includes the two diagrams reproduced below.



and

2



Audit committee reporting of significant issues

The inter-relationship between the UK Corporate Governance Code and the requirements of UK Auditing Standards

Compliance with Code Provision C3.8 (see Appendix 2) of the Code requires that a separate section of the Annual Report should describe the work of the Audit Committee in discharging its responsibilities and include, among other things, “The significant issues that the committee considered in relation to the financial statements and how these issues were addressed”. One of the matters that the Audit Committee considers in this regard is the communication required by Auditing Standards (see Appendix 2) from the auditor to the Audit Committee “About business risks relevant to financial reporting objectives, the application of materiality and the implications of their judgments in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified”.

Although “significant issues” reported by the Audit Committee are not necessarily identical to the “risks of material misstatement” that the auditor is required to include in an extended auditor’s report it is not unreasonable to expect them to be closely aligned. As part of our Survey we investigated the alignment between the content of Audit Committee reports and extended auditor’s reports.

Numerical analysis

For the companies whose auditor’s reports we surveyed, we have compared the significant issues reported by the Audit Committee to the risks reported by the auditor. Table 18 sets out the comparison by Sector.

TABLE 18 Numerical analysis of issues reported by Audit Committees compared to risks reported in auditor's reports

Sector	Average number of issues reported by Audit Committee per company in sector	Average number of total risks reported by auditors in sector	Average number of risks/issues reported by both auditor and Audit Committee	(3) as a % of (1)
	(1)	(2)	(3)	(4)
Banks & Financial Services	4.4	4.0	3.1	70%
Basic Materials	3.4	3.6	2.8	82%
Business Services	6.0	4.0	4.0	67%
Commercial Properties	3.8	3.6	2.4	63%
Construction Services	3.4	2.8	2.2	65%
Consumer Goods & Services	4.6	4.6	3.4	74%
Health Care	5.0	3.8	3.3	66%
Industrials	4.2	4.1	3.6	86%
Information Technology	4.3	3.9	3.4	79%
Insurance	4.1	4.5	3.3	80%
Metals & Mining	6.0	4.5	4.5	75%
Natural Resources	4.3	4.4	3.4	79%
Oil & Gas	4.5	7.0	3.5	78%
Regulator/Professional Body	4.0	3.0	1.0	25%
Retail	5.1	4.7	3.3	65%
Support Services	3.7	3.9	3.3	89%
Telecommunications	4.2	5.4	3.8	90%
Utilities	3.0	4.0	3.0	100%
All companies	4.3	4.2	3.2	74%

The average number of issues reported by the Audit Committee at 4.3 is broadly the same as the number of risks reported by the auditor at 4.2. However, although the overall quantum is similar, from the right hand column it can be seen that on average the auditor reported 74% of the risks that were reported by the Audit Committee.

There is nothing in either Auditing Standards or the Code that calls for exact alignment of the number of risks/significant issues reported. However, although auditors and Audit Committees may describe different risks/significant issues we believe that an alignment of 74% is within the range of reasonable expectations. Table 18 also shows that there is a reasonably consistent range across sectors that include listed companies of between 63% and 100%.

Appendix 4 to this Review sets out the auditor's report of Bodycote plc⁷ and Appendix 5 the related Report of the Audit Committee. As can be seen from Table 19 the auditor has reported on 80% of the matters reported by the Audit Committee.

⁷ Bodycote has been selected as a reasonably typical example of an extended auditor's report. It was not selected because it is regarded as being either a particularly good or bad example.

TABLE 19 Comparison of the report of the Audit Committee and the auditor's report of Bodycote plc

Report of the Audit Committee	Auditor's report
Principal areas of judgment (headings only)	Assessment of risk of material misstatement (headings only)
Impairment of goodwill, intangible and tangible fixed assets	Impairment of non-current assets
Restructuring, reorganisation and environmental provisions	Environmental provisions
Taxation	Taxation
Pension Liabilities	Pensions
Going Concern	-

The extended auditor's report addresses 4 of the 5 (80%) areas of judgment reported by the Audit Committee.

Subjective analysis

The descriptions of significant issues in the Audit Committee reports are almost invariably more concise than the descriptions of the equivalent risk in the auditor's report. The differential in length of explanation has arisen largely as a result of the practice of many audit engagement partners of describing, often in a table, the audit response to the risk. These explanations are frequently quite detailed and as a result it seems almost inevitable that the explanations and the corresponding responses thereto will be more comprehensive in the auditor's report than in the Audit Committee report.

Although admittedly subjective we have considered how well the Audit Committee's report and the auditor's report complement each other and also which of the reports communicate the issue/risk most effectively.

We concluded that 138 out of our sample of 153 (90%) auditor's reports complemented the Audit Committee reports well.

We further concluded that the auditor's report generally seems to be more informative with respect to the reporting of risks of material misstatement than the report of the Audit Committee with respect to significant issues. This was the case in 56% of our overall sample and 77% of our sample of FTSE 100 companies. Although entirely speculative, we attribute this outcome to a combination of the following factors:

- Auditors embracing the disclosures of risks more wholeheartedly than the Audit Committee.
- Auditors being able to devote considerably more man hours to the identification and articulation of risks.
- The fact that Audit Committees report in a derivative way rather than reporting their own findings.
- Audit Committees seeking to be more clear and concise.

In its Report "Developments in Corporate Governance and Stewardship 2014" the FRC noted that based on a sample of 10 per cent of FTSE 350 Audit Committee reports "a third (were) rated as needing to produce more effective explanations of the work done in relation to areas of judgment and estimates in the accounts".

THE VIEWS OF INVESTORS – THE IMA AUDITOR REPORTING AWARDS

An important source of evidence of investor views regarding extended auditor's reports can be found in the comments of the judges of the Investment Management Association's (IMA) Auditor Reporting Awards which were presented in November 2014.

The IMA awards ceremony, which was held in partnership with Schroders, recognised the progress being made in auditor reporting and in particular aimed "to laud those reports that were the most insightful and those that were the most innovative". The IMA appointed a panel of six, consisting of investors and Audit Committee chairs to judge the auditor's reports.

In the Insightful Category, the judges were looking for reports which:

- a) Are entity specific;
- b) Clearly outline the scope of the audit;
- c) Provide genuine insight into, and, link the risks of material misstatement and the auditor's response;
- d) Clearly explain the auditor's application of the concept of materiality;
- e) Are informative for users; and
- f) Provide users with discussion topics for engagement.

The Insightful Category is about those reports that provide the most entity specific and enlightening report, giving investors hooks on which to engage further with the Audit Committee.

In the Innovative Category, the judges were looking for reports which:

- a) Show innovation that goes further than the minimum requirements in Auditing Standards in order to provide insight and relevance to users;
- b) Have new and innovative presentation; and
- c) Include narrative that is innovative in communicating detail to investors.

The innovative category is about those reports which have really thought differently about how to present the findings so that they are set out in the most engaging and readable way.

The judges likes and dislikes about the way in which particular aspects of the new requirements have been implemented was set out by the judges as follows:

“On materiality – the judges found that there is often very little discussion around why the level of materiality was chosen in that, in the majority of cases, it was just given as a number. Investors would like to see more information as to why the level of materiality was chosen and if there was any discussion with the Audit Committee on it. The judges did like, however, where auditors gave the impact the total unadjusted differences reported to the Audit Committee would have had on profit, net assets and equity.

In many instances the descriptions of scope were quite boilerplate. What the judges did like is when they got a clear picture of the percentage of particular components such as revenue or assets that were audited by the group audit team and which by other auditors and the percentage that had been covered by analytical review procedures.

Specifically on the risks of material misstatement, the judges liked:

- Risks that are entity specific and described in detail, using simple and engaging language. The judging panel were put off by boiler plate disclosures, which lead to more questions than answers.
- An overview of the approach and the actions taken by the auditor to address the risk.
- Quantification of the individual risks so that investors can assess their materiality
- What the auditor found, whether the company’s approach was satisfactory or whether the auditor questioned management’s judgment. Those auditor reports which included the auditor’s findings and graduated those findings were the most insightful and engaging for investors. Bringing the report to life, not just about the process, but what the auditor found – they turned over the rock. These reports also stated if significant errors had been found that resulted in adjustments being made.

As regards presentation, the judges liked those reports that were clear and had an engaging layout, for example, through the use of tables and charts. They also welcomed the fact that the majority of the reports put the opinion up front and referred to legal requirements either at the end of the report or through web links. Clear referencing to notes to the accounts and the Audit Committee report were also considered important.

The judging panel noted that there was a considerable difference in the standard of reporting in the FTSE 100 compared to the FTSE 250 and FTSE Small Cap indices. They understand that this might be a factor of the simplicity of the businesses but would expect the auditor reports of smaller companies to follow the lead of the best practice seen in the FTSE 100 this year”.

Some of the comments made by the judging panel with respect to individual auditor’s reports to which they gave awards are also illuminating.

Innovative

With respect to innovation the judges commented as follows:

FTSE 100

Smiths Group plc (PwC) (Winner)

- The report was clearly structured in a format which made it easy to read so that a reader can quickly see what is of interest. For example there is an Executive Summary of the materiality, scope and key areas of focus.
- Unlike other reports, it provided a rationale for the choice of materiality level
- The report provided clear referencing to the notes to the accounts and quantified the value of the risks.

ITV plc (KPMG) (Commended)

- A very engaging read, with the use of tables, the risks are outlined in order of magnitude and discussed using simple language.
- Innovative use of web links for scope and responsibilities so as not to obscure the key focus.

FTSE 250

JD Wetherspoon plc (PwC) (Winner)

- The judging panel like the simplicity of the language and lack of jargon
- The judges particularly liked the detail of the risks outlined and the auditor's response – not just what work was performed but why.
- There is an overview on the first page which provides a unique one stop description of the key highlights – materiality, scope and areas of focus.

Merlin Entertainments plc (KPMG) (Commended)

- The judging panel thought that the report was very clear, using a graphic to set out the % of revenue audited by the group audit team, that by component auditors, and that by other procedures.
- Innovative use of web links for scope and responsibilities so as not to obscure the key focus.

FTSE small cap and AIM

Petropavlovsk plc (Deloitte) (Winner)

- The report has a very engaging layout with the use of tables and charts.
- The auditor raised the issue of going concern straight away and it was felt it was handled well.
- Highlighted all the key aspects of the major issues.

Insightfulness

With respect to insight the judges commented as follows:

FTSE 100

Rolls Royce Holdings plc (KPMG) (Winner)

- The judging panel was impressed with the level of detail and information in the auditor's report. The report provides significant insight into the audit process and the issues which the auditor had to consider.
- Investors could use the issues to have further engagement with the Audit Committee.
- Under the assessment of risks of material misstatement, the auditor outlines the risk, the auditor's response and importantly what they found. The inclusion of finding was a step further than other auditors and provided a real value add, giving colour as to whether management's judgments were balanced, mildly optimistic or mildly pessimistic in the view of the auditor. The auditor turned over the rock and reported what they had found.

Vodafone Group plc (Deloitte) (Commended - joint)

- The judging panel liked the detail and discussion of Vodafone's risks to the audit process and the inclusion of the total unadjusted errors detected during the audit and the impact this would have had on the loss before tax.

Standard Chartered plc (KPMG) (Commended - joint)

- The Panel particularly liked the auditor's discussion of risks which were focused on shareholder interests particularly in relation to the valuation of assets and impairment of loans in different countries.

FTSE 250

Rathbone Brothers plc (KPMG) (Winner)

- The judging panel felt this was a well written company specific report with good detail on the risks and the specific evidence the auditor sought
- It provided clear referencing and simple language on the risks to the audit.

Kazakhmys plc (KPMG) (Commended)

- The judges commended the auditor's report of Kazakhmys for being very informative and well written given the complexity of the business and the issues being discussed.
- Like Rolls Royce the findings are graduated rather than binary and give shades of judgment.

FTSE small cap and AIM

Stobart Group plc (KPMG) (Winner)

- Well written and detailed report with very entity specific risks.
- The issues were raised well and in particular the judging panel liked the discussion on the adequacy of disclosures and the competency of the valuer.
- In some ways the judging panel felt this report was better than some of the reports in the FTSE 250.

New World Resources plc (KPMG) (Commended)

- A very insightful report outlining not only the risks and the auditor's response, but also their findings and judgments.
- Like Rolls Royce and Kazakhmys the findings are graduated.

EMERGING FEEDBACK FROM AUDIT QUALITY REVIEW

Although the overall message from this Review is upbeat regarding progress made by the audit firms in writing the new style auditor's reports, a cautionary note is emerging from the work of the FRC's Audit Quality Review Team.

During the FRC's Audit Quality Reviews, the FRC assesses whether the descriptions of work undertaken by auditors in extended auditor's reports are consistent with the evidence of the work actually performed. In some instances the FRC has identified inaccuracies in the auditor's descriptions of the nature or extent of the audit procedures performed. The FRC has brought these matters to the attention of the relevant audit firms and reminded all the major firms of the importance of ensuring that their auditor's reports accurately reflect the work performed.

ASPIRATIONS FOR FUTURE DEVELOPMENTS

Developments since the reporting period covered by the Survey

There have been some interesting further developments since the period covered by the Survey:

- KPMG has announced that, in the second year of reporting, it is prepared to report its audit findings (along the lines of the Rolls Royce auditor's report) on a voluntary basis in auditor's reports of all of the listed companies they audit if the Audit Committee supports them in doing so.
- Deloitte in its second extended auditor's report on Vodafone plc has reported the quantum of unadjusted differences (i.e. uncorrected misstatements that were identified by the audit but were not individually or collectively material and were not adjusted by Vodafone plc) and has also explained what the effect on profit before tax would have been had the adjustments been booked.

Meetings with auditors and investors

Following completion of the Survey we have held a number of meetings (between October and January 2015) with investors and audit firms to both discuss the findings from our Survey and, more importantly perhaps, to seek their views on the first year of implementation and their plans and aspirations looking forward to the second year and beyond. Our findings from these meetings are summarised below.

Investors encouraged by first year response

In the main, investors have warmly welcomed the overall response by auditors to the extended auditor's report requirements, but with some cautionary notes.

For example, some have pointed to the risk that in "smoke filled rooms" auditors and Audit Committee members may convince themselves that it is acceptable to report a matter as a risk of material misstatement in the auditor's report in preference to reporting an emphasis of matter or expressing an "except for" opinion. If such a failure to comply with key requirements of the underlying auditor reporting standards were to occur it would clearly weaken trust in the auditor's report.

A second cautionary note related to the implications of partner or audit firm rotation, given that the incoming engagement partner may take a different view of what might constitute a risk of material misstatement and/or of materiality and as a result could significantly change the scope of the audit. One investor expressed a concern that a change in audit partner or audit firm should not enable risk disclosure arbitrage and that the auditor should provide explanations in the auditor's report when such changes occur.

Auditors learning from innovation and looking for ongoing investor feedback

Auditors have embraced the challenges of the new reporting requirements, experimenting with a number of innovative approaches and responding to feedback even within the reporting season. They are encouraged by the level of investor interest, notably demonstrated through the IMA awards programme, and are looking for further dialogue and feedback to help them develop their responses further in the next reporting season.

We have heard that investor interaction with Audit Committees and auditors about the new reporting requirements will be important in shaping auditors responses in a manner that most effectively meets market needs. Experimentation and innovation are a necessary part of this process. Investors and auditors

we spoke to highlighted considerable scope for further experimentation and innovation within the scope of the new requirements. They also highlighted a number of aspirations for developments that may go beyond the new requirements.

Perceived scope for improvements within the framework of the new requirements

Improving the granularity of reporting of risks

In this Review we have commented (see page 21) on our evaluation of the granularity of the reporting of risks. The auditor reporting standard requires risks to be described in a way that enables them to be related directly to the specific circumstances of the audited entity. The high value that is placed on granular reporting can be seen in the comments of the IMA judging panel on pages 52 and 53. Many of the audit firms, have commented that they appreciate the importance of granular reporting and they are encouraging their engagement partners to respond accordingly.

With respect to the reporting of risks we have heard comments from investors that:

- The discussion of risks should differentiate between routine and extreme risks (it is recognised that ultimately there may be cross over here with the audit approach to going concern disclosures);
- Auditors should be encouraged to discuss the implications for the audit of more intangible risks such as reputational risk to the reporting entity. (In this regard one investor commented favourably on Deloitte's auditor's report on Vedanta plc)
- The audit implications of risks inherent in the entity's business model should be discussed by the auditor;
- After the first year of reporting the auditor should be encouraged to explain the circumstances giving rise to new risks reported and to explain why risks that were previously reported are no longer being reported.

Materiality

Investors are particularly interested in information about the auditor's application of materiality. Both investors and the audit firms comment that the complexities and technicalities associated with applying the concept of materiality make it a difficult subject to communicate effectively about. There may be a need for explanatory or educational material to make discussion about this more accessible to some users. Some investors consider that there may be a role for the FRC in developing a common understanding.

Although investors welcome the quantitative information about overall materiality many of them would like more information about why a particular benchmark has been chosen and why, for example, 5% of the benchmark is almost invariably the threshold measurement that is used. Also some disappointment has been expressed that only one of the larger accounting firms (EY) consistently discloses performance materiality which can convey important messages about the auditor's assessment of the entity's control environment.

Investors are particularly concerned about a perceived dearth of information about qualitative materiality in auditor's discussion of materiality; for example in relation to the disclosure of related party transactions.

Disclosure of comparatives and explanations of changes from year to year

Some investors commented that the disclosures on risks of material misstatement were satisfactory in-so-far-as they went but that they would like them to go much further. These investors suggested that auditors, when reporting on risks of material misstatement, could provide much more useful information for investors if they:

- Indicated where a company placed itself with respect to competitors in its industry (industry benchmarking);
- Went further than merely stating that accounting estimates were “reasonable” and instead indicated (qualitatively) where within the range of acceptable outcomes an estimate lay.

Investors appreciated the disclosure of comparative information disclosed by EY in most of its auditor’s reports. However, they would like the disclosure of comparative information by all auditors and the disclosure of more comparative information. In particular, one investor would like disclosure where an accounting estimate moves within the range of acceptable outcomes from one year to another, for example, being at the optimistic end of a range in the current year but at the pessimistic end of the range in the previous year. Quantification of the effect on the results of such movements would also be welcomed by this investor.

Providing a commentary on audit scope

One investor suggested that auditors should be encouraged to provide a commentary on the description of audit scope in order to provide more colour. This investor cited EY’s report on BP plc as a good example in this regard in mentioning that the engagement partner had visited Houston four times during the audit to consider uncertainties over provisions and contingencies and Moscow three times to consider whether BP exercised significant influence over an associate.

Aspirations for improvement that may go beyond the new requirements

Differences between matters raised by Audit Committee and auditors

Investors recognise that the auditor’s report and Audit Committee report are not required to mirror one another and appreciate that there are likely to be differences between the matters raised by the Audit Committee and those raised by the auditor in their respective reports. However, some investors considered that where an auditor raises as a risk an issue that the Audit Committee does not address at all, there should be a requirement for a discussion within either the auditor’s report or the Audit Committee report as to why this is. To make such a change mandatory for auditors would require a change to be made to the auditor reporting standard.

The reporting of findings by the auditor

In our Survey, we noted the experiment undertaken by one engagement partner at KPMG to report the auditor’s findings in respect of the risks of material misstatement identified in the auditor’s report (see pages 23 to 25). The auditor’s reports of Rolls Royce Holdings plc, Kazakhmys plc and New World Resources plc were the first example of such reports. All three of these reports were praised by the IMA judges, with Rolls Royce Holdings auditor’s report being judged the most insightful in the FTSE 100 and the others being commended by the judges.

We note above that KPMG are proposing to adopt the reporting of findings on a voluntary basis in auditor's reports of listed companies where Audit Committees support them in doing so. Other audit firms have similarly observed the degree of interest and enthusiasm being shown in these reports by certain investors and are considering whether to adopt a similar approach in their own reports.

At this time the other firms appear to be more cautious in this area, either awaiting the outcome of the KPMG initiative or considering this primarily where investors or Audit Committees encourage them to do so on a case by case basis. Some are taking this approach because they are aware of resistance to this development among some Audit Committees and are of the view that there ought, ideally, to be safe harbour provisions to protect auditors in going this extra step. Mandating the reporting of findings would require a change to be made to the auditor reporting standard but investor dialogue with Audit Committee and auditors could also help them to understand whether this is something they want auditors to do more generally.

Reporting the auditor's findings in the preliminary announcement

A number of those with whom we have had discussions commented that, since the publication of the Annual Report does not typically "move the market" it may be more beneficial for investors if the auditor's report were to be published with the preliminary announcement and also, perhaps, in conjunction with investor relations road shows. (Although one investor that we spoke to preferred to keep the preliminary announcement on a "binary basis" and to restrict the extended auditor's report to the Annual Report because this investor considered that the Annual Report rather than the preliminary announcement is the key stewardship document)

The Listing Rules currently require preliminary announcements to, among other things:

- a) be agreed with the company's auditor prior to publication;
- b) give details of the nature of any likely modification that may be contained in the auditor's report required to be included in the Annual Report; and
- c) include any significant additional information necessary for the purpose of assessing the results being announced.

When the current Listing Rules were written the concept of the extended auditor's report did not exist. The required content of preliminary announcements falls within the ambit of the UK Listing Authority of the FCA. However, companies and their auditors may wish to regard the information contained in the extended auditor's report as constituting "significant additional information necessary for the purpose of assessing the results being announced".

Publishing the audit plan

A number of audit firms and investors observed that reporting the scope of the audit and the materiality threshold in the auditor's report in the Annual Report does not provide an opportunity for investors and other interested parties to challenge such scoping and threshold judgments. Although the precise mechanism for doing this had not been considered in detail by those we spoke to, there was an aspiration for the audit plan to be made public once it has been discussed with the Audit Committee and thus provide an opportunity for stakeholders to consider and challenge the audit plan.

Reporting on the quality of a company's systems

Some that we spoke to, commented on the fact that the requirement in the auditor reporting standard for risks of material misstatement to be described may be implemented with an undue focus on reporting risks to the financial statements to the detriment of reporting risks arising from the quality of the company's systems. Although the Auditing Standards do not differentiate between risks to the financial statements and system risks some commentators were of the view that there ought to be more encouragement in the Standards for reporting issues arising from the quality of company's systems.

Making such a change may not need additional requirements to be included in the auditor reporting standard but could be addressed through additional "Application and Other Explanatory Material."

Appendix 1

The requirements and guidance relating to the extended auditor's report in ISA (UK and Ireland) 700 (Revised June 2013) "The Independent Auditor's Report on Financial Statements"

REQUIREMENTS

Entities that Report on Application of the UK Corporate Governance Code

- 19A In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor's report shall:
- (a) Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.
 - (b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole.
 - (c) Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b).
- 19B In order to be useful to users of the financial statements, the explanations of the matters required to be set out in the auditor's report by paragraph 19A shall be described:
- So as to enable a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements.
 - In a way that enables them to be related directly to the specific circumstances of the audited entity and are not, therefore, generic or abstract matters expressed in standardised language.
 - In a manner that complements the description of significant issues relating to the financial statements, required to be set out in the separate section of the Annual Report describing the work of the Audit Committee in discharging its responsibilities. The auditor seeks to coordinate descriptions of overlapping topics addressed in these communications, to avoid duplication of reporting about them, whilst having appropriate regard to the separate responsibilities of the auditor and the Board for directly communicating information primarily in their respective domains.

APPLICATION AND OTHER EXPLANATORY MATERIAL

Entities that Report on Application of the UK Corporate Governance Code (Ref: Para 19A)

A13A Such assessed risks of material misstatement are likely to have been identified by the auditor in meeting the requirements of ISA (UK and Ireland) 315 “Identifying and assessing the risks of material misstatement through understanding the entity and its environment”, including those relating to significant risks. However, the auditor uses its judgment to determine which, if any of the significant risks and which, if any, of the other identified risks meet the criteria set out in paragraph 19A(a) and are to be described in the auditor’s report. If the auditor significantly revises its risk assessment during the audit the auditor considers whether to disclose that fact and the circumstances giving rise to the changed assessment.

A13B The explanation of how the auditor applied the concept of materiality in planning and performing the audit, is tailored to the particular circumstances and complexity of the audit and, in addition to specifying the threshold used by the auditor as being materiality for the financial statements as a whole, might include, for example:

- Materiality level or levels for those classes of transactions, account balances or disclosures where such materiality levels are lower than materiality for the financial statements as a whole (as described in paragraph 10 of ISA (UK and Ireland) 320.
- Performance materiality (as described in paragraph 11 of ISA (UK and Ireland) 320.
- Any significant revisions of materiality thresholds that were made as the audit progressed.
- The threshold used for reporting unadjusted differences to the Audit Committee.
- Significant qualitative considerations relating to the auditor’s evaluation of materiality.

A13C The content of the overview of the scope of the audit is tailored to the particular circumstances of the audit and how the scope was influenced by the auditor’s application of materiality and addressed the assessed risks of material misstatement described in the auditor’s report. Such a summary might also include, for example:

- The coverage of revenue, total assets and profit before tax achieved.
- The coverage of revenue, total assets and profit before tax of reportable segments achieved.
- The number of locations visited by the auditor as a proportion of the total number of location, and the rationale underlying any programme of visits.
- The effect of the group structure on the scope. The audit approach to a group consisting of autonomous subsidiary companies may differ from that applied to one which consists of a number of non-autonomous divisions.
- The nature and extent of the group auditor’s involvement in the work of component auditors.

Appendix 2

The relevant Principles included in the September 2012 UK Corporate Governance Code and the related requirements and guidance in ISA (UK and Ireland) 260 (Revised October 2012) “Communication with Those Charged with Governance”

UK Corporate Governance Code

C.1: Main Principle

The board should present a fair, balanced and understandable assessment of the company’s position and prospects.

C1.1: The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider 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. ...

C.2: Main Principle

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

C2.1 The board should, at least annually, conduct a review of the effectiveness of the company’s risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.

C3: Main Principle

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company’s auditors.

C3.4: Where requested by the board, the Audit Committee should provide advice on whether 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.

C.3.8: A separate section of the annual report should describe the work of the [audit] committee in discharging its responsibilities. The report should include:

- The significant issues that the committee considered in relation to the financial statements and how these issues were addressed; ...

ISA (UK and Ireland) 260 (Revised October 2012) “Communication with those charged with governance”

16-1 In the case of entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor shall communicate to the Audit Committee the information that the auditor believes will be relevant to:

- The board (in the context of fulfilling its responsibilities under Code provisions C1.1 and C2.1) and, where applicable, the Audit Committee (in the context of fulfilling its responsibilities under Code provision C.3.4); and
- The Audit Committee (in the context of fulfilling its responsibilities under Code provision C.3.2) in order to understand the rationale and the supporting evidence the auditor has relied on when making significant professional judgments in the course of the audit and in reaching an opinion on the financial statements.

If not already covered by communications under paragraphs 15 and 16 above, this information shall include the auditor’s views:

- (a) About business risks relevant to financial reporting objectives, the application of materiality and the implications of their judgments in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified;

[Detailed matters (b) to (e)]...

Appendix 3

The FRC's Pro Forma Illustrative Auditor's Report

Example 9 - Publicly traded premium listed group – Auditor's report on group financial statements prepared under IFRSs as adopted by the European Union

- Company is a quoted company and has a premium listing.
- Corporate governance statement reported on in the auditor's report on the group financial statements and incorporated into the directors' report, either directly or by incorporation by reference as explained in APB Bulletin 2009/4 (see example 7 for an illustration of an auditor's report where the corporate governance statement is not incorporated into the directors' report).
- Directors' Remuneration Report reported on in the auditor's report on the parent company financial statements.
- Company does prepare group financial statements.

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF XYZ PLC

We have audited the group financial statements of (name of company) for the year ended ... which comprise [specify the titles of the primary statements such as the Group Statement of Financial Position, the Group Statement of Comprehensive Income, the Group Statement of Cash Flows, the Group Statement of Changes in Equity]⁸ and the related notes⁹. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement [set out [on page ...]], the directors are responsible for the preparation of the group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's [(APB's)] Ethical Standards for Auditors.

⁸ The names used for the primary statements in the auditor's report should reflect the precise titles used by the company for them.

⁹ Auditor's reports of entities that do not publish their financial statements on a website or publish them using 'PDF' format may refer to the financial statements by reference to page numbers.

Scope of the audit of the financial statements

Either:

A description of the scope of an audit of financial statements is [provided on the FRC's website at www.frc.org.uk/auditscopeukprivate] / [set out [on page ...] of the Annual Report].

Or:

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the [describe the Annual Report] to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the group financial statements:

- give a true and fair view of the state of the group's affairs as at and of its profit [loss] for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Our assessment of risks of material misstatement

[Insert a description of those specific assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on the audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.]

Our application of materiality

[Insert an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole.]

An overview of the scope of our audit

[Insert an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement and was influenced by the auditor's application of materiality.]

[The disclosures about the above three matters are made in a manner that complements the description of significant issues relating to the financial statements required to be set out in the separate section of the Annual Report describing the work of the Audit Committee in discharging its responsibilities (see paragraphs [19B] and A13D] of ISA (UK and Ireland) 700).

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Strategic Report and the Directors' Report for the financial year for which the group financial statements are prepared is consistent with the group financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the ISAs (UK and Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- is otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the Annual Report is fair, balanced and understandable and whether the Annual Report appropriately discloses those matters that we communicated to the Audit Committee which we consider should have been disclosed.

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, [set out [on page...]], in relation to going concern; and
- the part of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the UK Corporate Governance Code specified for our review.

Other matter

We have reported separately on the parent company financial statements of (name of company) for the year ended ... and on the information in the Directors' Remuneration Report that is described as having been audited. [That report includes an emphasis of matter] [The opinion in that report is (qualified)/(an adverse opinion)/(a disclaimer of opinion)].

[Signature]

Address

John Smith (Senior statutory auditor)

Date

for and on behalf of ABC LLP, Statutory Auditor

Independent auditor's report

To the Members of Bodycote plc

Opinion on financial statements of Bodycote plc

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the parent company's affairs as at 31 December 2013 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- the parent company financial statements have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

The financial statements comprise the Consolidated Income Statement, the Consolidated Statement of Comprehensive Income, the Consolidated and Company Balance Sheets, the Consolidated Cash Flow Statement, the Consolidated Statement of Changes in Equity, the Statement of Group and Company Accounting Policies and the related notes 1 to 28 and 1 to 11 for the Group and Company financial statements respectively. The financial reporting framework that has been applied in the preparation of the Group financial statements is applicable law and IFRSs as adopted by the European Union. The financial reporting framework that has been applied in the preparation of the parent company financial statements is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

Going concern

As required by the Listing Rules we have reviewed the directors' statement on page 23 that the Group is a going concern. We confirm that:

- we have concluded that the directors' use of the going concern basis of accounting in the preparation of the financial statements is appropriate; and
- we have not identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Group's ability to continue as a going concern.

Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team:

Risk	How the scope of our audit responded to the risk
<p>Impairment of non current assets</p> <p>Given the Group's significant asset base and the continued macro-economic uncertainties in certain global territories, this risk concerns the carrying value of intangible and tangible fixed assets. The Group's assessment of the carrying value of intangible and tangible fixed assets requires significant judgement, as described in note 10 with particular attention to cash flow, growth rates, discount rates and sensitivity assumptions.</p>	<p>We challenged the assumptions used in the impairment model for intangible and tangible assets, described in note 10. As part of our procedures we considered historical trading performance by comparing recent growth rates of both revenue and operating profit across the Group's geographical and market segments, assessing the appropriateness of the assumptions concerning growth rates and inputs to the discount rate against latest market expectations, and considering management's assertions of the future utilisation of assets by the Group following a review of the strategic plan for the business by CGU. In performing our procedures, we used our internal valuation specialists and third party evidence to assess the appropriateness of the discount rate applied.</p>
<p>Environmental provisions</p> <p>Given the nature of the Group's operations, a risk arises in connection with the appropriateness, completeness and valuation of environmental provisions, in particular, their judgemental nature relative to the likely period of utilisation.</p>	<p>We evaluated the environmental provisions, as detailed in note 22 to the financial statements, by testing the basis for the recognition of provisions in consideration of those regulatory and legal requirements, assessing the value of the provision recognised and challenging the status and utilisation of provisions. As part of our audit procedures we reviewed third party evidence and assumptions detailing the assessment of environmental liabilities for the Group together with correspondence from the Group's internal environmental remediation team. As part of these procedures we also challenged the qualifications of management's experts. Where applicable, we also corroborated environmental provisions to regulatory and legal correspondence.</p>

Independent auditor's report continued

To the Members of Bodycote plc

Risk

How the scope of our audit responded to the risk

Taxation

The tax risk concerns the judgements and estimates applied in the determination of tax balances, in particular in relation to the recognition of deferred tax assets for tax losses across the Group as disclosed in note 19 and provisions for liabilities attributed to specific uncertain tax positions linked to the Group's complex corporate structure.

In conjunction with taxation audit specialists, we have considered and challenged the appropriateness of management's assumptions, forecasts and estimates in relation to the likelihood of generating future taxable, as opposed to accounting, profits to support the recognition of deferred tax assets as disclosed in note 19 to the financial statements.

We have also assessed the assumptions and judgements concerning the adequacy of tax provisions for uncertain tax positions by viewing the latest correspondence from the different tax authorities and drawing on the experience of our country specialists in respect of similar situations.

Pensions

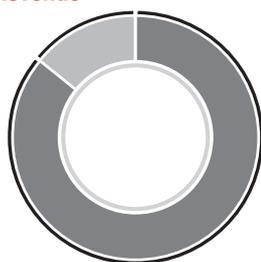
This risk concerns the appropriateness of actuarial assumptions in calculating the Group's IAS 19 liability. The valuation of the Group's IAS 19 deficit involves significant judgement as described in note 28, in particular in relation to the discount rate, inflation and mortality assumptions.

We have considered the appropriateness of the assumptions underpinning the valuation of scheme assets and liabilities. Specifically we challenged the discount rate, inflation and mortality assumptions applied in calculating the scheme liabilities by using our internal pension specialists to assess and benchmark the assumptions applied against comparable third party data.

The Audit Committee's consideration of these risks is set out on page 44.

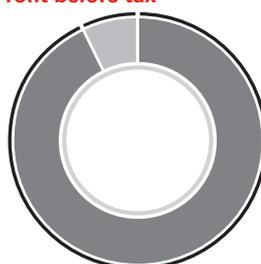
Our audit procedures relating to these matters were designed in the context of our audit of the financial statements as a whole, and not to express an opinion on individual accounts or disclosures. Our opinion on the financial statements is not modified with respect to any of the risks described above, and we do not express an opinion on these individual matters.

Revenue



■ Full audit scope 86%
■ Review at group level 14%

Profit before tax



■ Full audit scope 93%
■ Review at group level 7%

Our application of materiality

We define materiality as the magnitude of misstatement in the financial statements that makes it probable that the economic decisions of a reasonably knowledgeable person would be changed or influenced. We use materiality both in planning the scope of our audit work and in evaluating the results of our work.

We determined materiality for the Group to be £6.8 million, which is below 75% of adjusted pre-tax profit and 1% of equity. We use adjusted pre-tax profit to exclude the effect of volatility from our determination. Adjusted pre-tax profit excludes non-recurring exceptional items of £0.8 million as disclosed in note 3.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £145,000, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds. We also report to the Audit Committee on disclosure matters that we identified when assessing the overall presentation of the financial statements.

An overview of the scope of our audit

Our Group audit was scoped by obtaining an understanding of the Group and its environment, including Group-wide controls, and assessing the risks of material misstatement at the Group level. Based on that assessment, we focused our group audit scope primarily on the audit work at 15 locations. In addition, following the reorganisation of a number of the Group's finance functions into a Shared Service Centre in Prague, we planned and performed our audit work and the shape of audit teams for the countries affected to focus on direct Group oversight, leadership and control in the first year of transition.

As a consequence of the audit scope determined, we achieved full scope coverage of approximately 86% of revenue, 93% of profit before tax, and 87% of net assets. Our audit work at each location was executed at levels of materiality applicable to each individual entity which was lower than Group materiality.

The Group audit team continued to follow a programme of planned visits that has been designed so that a senior member of the Group audit team visits each of the locations included as full scope for the Group audit at least once every three years and the most significant of them at least once a year. In years when we do not visit a significant component we will include the component audit team in our team briefing, discuss their risk assessment, attend close meetings by conference call and video conferencing and review documentation of the findings from their work.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

Adequacy of explanations received and accounting records

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements are not in agreement with the accounting records and returns.

We have nothing to report in respect of these matters.

Directors' remuneration

Under the Companies Act 2006 we are also required to report if in our opinion certain disclosures of directors' remuneration have not been made or the part of the Directors' Remuneration Report to be audited is not in agreement with the accounting records and returns. We have nothing to report arising from these matters.

Corporate Governance Statement

Under the Listing Rules we are also required to review the part of the Corporate Governance Statement relating to the company's compliance with nine provisions of the UK Corporate Governance Code. We have nothing to report arising from our review.

Our duty to read other information in the Annual Report

Under International Standards on Auditing (UK and Ireland), we are required to report to you if, in our opinion, information in the annual report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group acquired in the course of performing our audit; or
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the annual report is fair, balanced and understandable and whether the annual report appropriately discloses those matters that we communicated to the audit committee which we consider should have been disclosed. We confirm that we have not identified any such inconsistencies or misleading statements.

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors. We also comply with International Standard on Quality Control 1 (UK and Ireland). Our audit methodology and tools aim to ensure that our quality control procedures are effective, understood and applied. Our quality controls and systems include our dedicated professional standards review team, and reviews by our strategically focused second partner and independent partner.

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Group's and the parent company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Nicola Mitchell (Senior statutory auditor)

for and on behalf of Deloitte LLP
Chartered Accountants and Statutory Auditor
Manchester United Kingdom
27 February 2014

Stock code: BOY

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Appendix 5

Report of the Audit Committee

Introduction

Our Committee has continued to focus on the integrity of Bodycote's financial reporting, risk management and internal controls and on the quality of the external and internal audit processes. We will continue to keep our activities under review as the regulatory environment changes. This year I have given more emphasis to the work actually done by the Committee in addition to the other matters we report upon.

Membership

The members of the Audit Committee are J. A. Biles, Dr K. Rajagopal and E. Lindqvist, all of whom are independent Non-Executive Directors. Their biographical details are shown on page 33 and their remuneration on page 59. The Company Secretary is the Secretary to the Audit Committee.

Mr Biles has been Chairman of the Audit Committee since 16 August 2007 when he was appointed a Director of the Company. The Board considers that Mr Biles has recent and relevant financial experience. He qualified as a Chartered Accountant with Price Waterhouse & Co, served as a plc Finance Director (FKI PLC 1998-2004 and Chubb Security PLC 1991-1997) and has chaired the Audit Committees of several other plcs.

Objective

The Committee's objective is to provide effective governance over the Group's financial reporting, including the adequacy of related disclosures, the management and oversight of the Group's systems of internal control, financial risks and the performance of internal audit and the external auditors.

Role and responsibilities

The Audit Committee is a sub-committee of the Board whose main role is to encourage and safeguard the highest standards of integrity, financial reporting, financial risk management and internal controls.

The responsibilities of the Audit Committee are set out in its Terms of Reference, which include all matters required by the Disclosure and Transparency Rules and the Code, and are available on the Company's website. These responsibilities include:

- reviewing the form and content of the interim and year end accounts and results announcements;
- reporting to the Board on the appropriateness of the Group's accounting policies and practices and significant areas of judgement;
- advising the Board on whether the Committee believes 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 strategy, business model and performance;
- reviewing risk management and internal controls;
- overseeing the relationship with the external auditors; and
- assessing the performance and reviewing the scope, results and effectiveness of internal audit.

Committee meetings

The Audit Committee met four times during 2013 and in February 2014 and all members attended all meetings. The Committee Chairman also invited the Chairman, Chief Executive, Group Finance Director, Group Financial Controller and Group Head of Risk to attend all meetings. Other Executives from the Group were also invited, as appropriate, to attend certain meetings to provide a deeper level of insight into key issues. The Committee Chairman also invited the external auditors, Deloitte LLP, to every meeting.

Mr Biles also had preparatory meetings separately with Deloitte and the Group Head of Risk prior to most Committee meetings to review their reports and discuss issues in detail.

Main activities of the Committee during the year

As part of the process of working with the Board to carry out its responsibilities and to maximise effectiveness, meetings of the Committee generally take place just prior to Board Meetings.

At its meetings, the Committee focused on the following main areas:

Financial reporting

The primary role of the Committee in relation to financial reporting has been to review with management and the external auditors the appropriateness of the interim and annual financial statements concentrating on, amongst other matters:

- the quality and acceptability of accounting policies and practices;
- the application and impact of significant judgements or matters where there was significant discussion with the external auditors;
- the clarity of disclosures and compliance with Financial Reporting Standards;
- whether the Annual Report and Accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Group's strategy, business model and performance; and
- correspondence with the Financial Reporting Council.

Reports from management were considered on significant matters, including in respect of litigation, treasury and tax matters and also reports from the external auditors on the outcome of their work. The committee challenged both management and Deloitte to ensure that the scope of the audit was appropriate and Deloitte had applied the necessary level of professional scepticism in their work.

Report of the Audit Committee continued

Principal areas of judgement

The principal areas of judgement considered by us in relation to the 2013 accounts were as follows.

- Impairment of goodwill, intangible and tangible fixed assets. The Committee challenged the assumptions, particularly the discount rate and growth factors, used in the discounted cash flow calculations for each cash generating unit, the sensitivity analysis applied and the projected future cash flows used to support the carrying values of the goodwill and intangibles and tangible assets.
- Restructuring, reorganisation and environmental provisions. The Committee received reports and challenged the basis and completeness of the assumptions used to calculate the provisions. In particular the Committee considered the increase in the reorganisation provision, relating to the transfer of accounting to the Shared Service Centre in Prague. The Committee discussed with management the key judgements behind all provisions and agreed with their recommendations.
- Taxation. A number of judgements are involved in calculating tax provisions and the level of deferred tax assets to be recognised. The Committee reviewed the associated risks and challenged management's assessment concerning the Group's key tax risks and management's forecast of the future profitability of the relevant businesses.
- Going Concern. The Committee challenged the validity of the Going Concern assumption used in preparation of the Annual Report and Accounts, in particular considering the Group's forecast liquidity position, available borrowing facilities, covenant compliance and sensitivity analysis.
- Pension Liabilities. Management took external professional advice in determining pension liabilities. The Committee challenged the assumptions used, particularly in respect of inflation, the discount rate and life expectancy.

Risk management

The Group's risk assessment process and the way that significant financial risks are managed and mitigated is a key area of focus for the Committee at each meeting. The committee work on risk was guided by the Group's assessment of its principal risks and uncertainties. At each meeting the Committee reviewed a report from the Group Head of Risk who has primary responsibility for developing the Group's risk management framework. The Committee reviewed changes to significant risks and mitigating actions identified by management. The Committee also received quarterly reports on calls to the Open Door Line (whereby employees may report matters of concern) and assessed both how such calls are dealt with and whether there was any indication of material risk. The Committee also reviewed and challenged the effectiveness of management's business continuity and disaster recovery arrangements.

Internal control

At each meeting the committee reviewed the process by which the Group evaluated its internal control environment. In particular we considered and challenged reports from the internal auditors on effectiveness of internal controls and requested certain changes to those controls. During the year there has been a focus on controls to minimise the risk of fraud.

Internal audit

The Group Head of Risk presented a report to the Committee at each meeting on the status of internal audit plans for the current year, points arising from audits completed and follow up action plans to address areas of weakness. We also received reports on actual or suspected frauds and thefts by third parties and employees. None had any material financial impact on the Group and where necessary, systems and procedures were altered to minimise the risk of recurrence. In December 2013 the plan for 2014 was presented to the Committee and accepted following discussion and challenge as to scope and areas of focus.

External audit

At the April and December meetings the external auditors presented their audit plans for the interim review and year end audit respectively. The Committee considered and challenged both the scope and materiality to be applied to the Group audit and its components. In particular the Committee considered carefully the scope in respect of smaller and more remote locations. As a consequence it decided that those few local audits that were not previously undertaken by Deloitte LLP would be for the 2013 audit.

Cyber risk

The members of the Committee completed the cyber risk questionnaire produced by the Department for Business Innovation and Skills and the Committee was further briefed on this important area by specialists from Deloitte LLP.

Training

Updates were presented to the Committee on any new accounting developments and any changes in corporate governance requirements that may affect the Group. Committee members also attended training briefings by accounting firms and other advisors.

Overview

The Committee reviewed the Annual Report and Accounts. Taken as a whole, in the light of their knowledge of the Group and its performance, the outcome of the activities described above and based on robust discussion with both management and the external auditors, the Committee has concluded that they are fair, balanced and understandable and provide the information necessary for shareholders to assess the Group's strategy, business model and performance, and reported to the Board accordingly.

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