Financial Reporting Council

Public Company Accounting Oversight Board's Public Meeting: The auditor's reporting model

Opening Statement of Nick Land:
Chairman Audit and Assurance Council, UK Financial Reporting Council

The Financial Reporting Council (FRC)
The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. It promotes high standards of corporate governance through the UK Corporate Governance Code. It also sets UK accounting and auditing standards and both monitors and enforces those standards.

Background to the changes to the auditor's report in the UK
Arising from its work on audit quality the FRC has been aware for some time of the concerns of users of auditor's report 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 for change.

The aftermath of the Financial Crisis of 2008 saw a significant increase in 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. In early 2011, the FRC issued a consultation paper "***Effective Company Stewardship – Enhancing Corporate Reporting and Audit"*** which led to the FRC concluding, among other things,

- 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.
- To revise the auditing standards governing reporting by auditors to audit committees and auditor's reports to make the contribution of auditors more transparent.

Overview of the changes made to the UK Corporate Governance Code in 2012
In 2012, arising from its 2011 Consultation, the FRC made simultaneous changes to the UK Corporate Governance Code and to the UK Auditing Standards to accomplish the above objectives. With respect to the Code a new Main Principle was introduced that "***The board should present a fair, balanced and understandable assessment of the company's position and prospects***". 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".

One of the supporting Code Provisions 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 Code Provision requires the Annual Report of a company to include a separate report describing the work of the audit committee 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 governing reporting by auditors to audit committees was revised to require the auditor to communicate to the audit committee the information the auditor believes will be relevant to the 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 reaching an opinion on the financial statements.

Overview of the changes made to the UK auditor's report

In making the changes described above the FRC was mindful of the widely held belief that information about a company is better disclosed by the company than by the auditor. The information, therefore, is disclosed by 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 boards 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 if the audit committee fails to do so.

In making the above changes the FRC considered that audit committees may be reluctant 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:

- 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.
- Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; and
- 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.

The above requirements are 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.

Experience to date with the new requirements

The changes described above apply primarily to companies having a premium listing on the London Stock Exchange. As the changes are effective for periods commencing on or after 1 October 2012 we are now seeing a significant number of extended auditor's reports appear.

I have been encouraged by the enthusiastic response of the auditing firms to the challenge set by the new requirements. It is already clear that the requirements are not giving rise to excessive boiler plate or legalistic auditor's reports. In many cases the auditor's reports seem quite frank and open about their discussion of the risks of material misstatement, the application of materiality and the scope of the audit. There is some evidence that the auditing firms see these new requirements as a way of distinguishing themselves from one another. Some engagement partners seem to be relishing the opportunity to demonstrate the depth of thinking and extent of management challenge that their audit entailed.

Initial reactions of investors to the new extended auditor's reports have also been very positive. In particular, the disclosures in the auditor's reports around the scope of the audit and the auditor's application of the concept of materiality have begun to generate discussion amongst stakeholders that may, in due course, result in a narrowing of the audit expectation gap.

When the current reporting season is over the FRC will evaluate the effectiveness of the requirements that it put in place and undertake outreach with its stakeholders to ascertain whether its objective of providing better insight into the audit process has been achieved.

I conclude by noting the FRC's encouragement for the IAASB's and PCAOB's work in this area. I hope that the FRC's work has shown that extended auditor's reports are a practical proposition and that this will be of help to both of these bodies.