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EXTENDED AUDITOR REPORTING – NARROWING THE AUDIT EXPECTATIONS GAP?



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After many years of debate, accentuated by the global financial crisis of 2008, questions arose about whether the binary pass/fail audit report remained fit for purpose and what could be done to indicate more clearly to investors the value of the audit and to narrow the audit expectations gap by enhancing confidence in financial reporting and audit.

In the past formulaic audit reports gave little indication of how auditors direct their efforts even though audit practice involved more sophisticated techniques and risk sampling than ever before. Certainly complex and subjective areas were discussed between auditors and Audit

Committees for some time but little if any of this was transparent to investors, or other users of the financial statements. This led to questions about how the value of the audit report could be enhanced. Auditing standard setters such as the IAASB and some regulators, and in particular the UK's Financial Reporting Council, started to address this in recent years through the new extended audit report.

Improving the auditor's report has been a priority for some time for global, US, and EU regulators and standard-setters. The UK mandated a new audit report for year ends in 2013 that served as a pathfinder for some of the IAASB's proposals

including Key Audit Matters (KAMs), and added further requirements. The IAASB itself issued its standards on extended audit reports in 2015. The EU Audit Directive now requires the inclusion of key observations where relevant. In the USA, the PCAOB published its standard in 2017 and will be rolling out its own similar but not identical Critical Audit Matters (CAMs) regime in late 2019. As this article will try to make clear these developments have been strongly welcomed by investors as well as other stakeholders. The introduction of KAMs and CAMs should in principle assist users by increasing the information value of the auditor's report.

The IAASB released a revised overarching standard (ISA 700 – Revised) in January 2015 which is compulsory for listed entities and came into effect for audits of financial statements for periods ending on or after 15 December 2016. It was introduced in response to the need to improve auditor communications, recognising that users want more relevant information about the audit of financial statements to aid decision making and stewardship, and as a basis for further engagement with the audited entity. IAASB's 'At a Glance' publication¹ details the key enhancements to the auditor's report.

Communicating Key Audit Matters in the Independent Auditor's Report (ISA 701), requires the auditor to:

- Determine those matters to be regarded as KAMs; and
- Communicate those matters in the auditor's report.

KAMs can be defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. They are selected from matters communicated with those charged with governance:

- Areas with increased risk requiring extra attention in the audit;
- Areas of auditor judgement relating to management judgements; and
- Significant events or transactions that have impacted the audit.

The IAASB identified various potential benefits which all make good intuitive sense but are still to be fully demonstrated:

- Enhanced communication between auditors and investors, as well as those charged with corporate governance;
- Increased user confidence in audit reports and financial statements;
- Increased transparency, audit quality, and enhanced information value;
- Increased attention by management and financial statement preparers to disclosures referencing the auditor's report;
- Renewed auditor focus on matters to be reported that could result in an increase in professional scepticism;
- Enhanced financial reporting in the public interest.

The UK was effectively the first adopter of the enhanced auditor reporting regime through the FRC's early introduction of similar standards in 2013, so a number of UK listed entities are now in 2018 into their fifth year of adoption. Although the UK standards are slightly different with additional disclosures required in relation to planning materiality and the scoping of the audit, the overall approach is broadly consistent with the IAASB. In essence this covers:

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

¹IAASB The New Auditor's Report: Greater Transparency into the Financial Statement Audit, January 2015

responded to the risks of material misstatement and the application of materiality.

Many lessons were learned from the adopting extended audit reports for the first time and the FRC was very keen to review the first and second years of UK extended auditor's reporting and to disseminate its findings.²

The FRC was able to increase the size of its sample in its second year review to cover 278 or nearly 80% of the premium listed FTSE 350 companies in the UK up from 153 or 44% in the first year so this can be regarded as a thorough and representative review.

The FRC observed that audit firms innovated significantly in the first year of extended auditor's reports. It was also found that the pace of innovation slowed in the second year. This may be useful in highlighting differences between audit firms in what is now a more competitive market through mandatory tendering and rotation of auditors of UK listed companies.

The FRC's key findings indicated that:

- Investors welcomed the information included in extended auditor's reports, and particularly for smaller companies where there tends to be less independent information available;
- In general, auditors have continued to move away from generic boilerplate language and descriptions of risk, making their reports more relevant and insightful;
- The reports which have earned the greatest praise from investors tend to be well structured, signposting key information and often make innovative use of graphics, diagrams and colour.

However, the FRC reported that investors expect more from enhanced audit reports including:

- Providing more complete information about the sensitivity ranges used in audit testing;
- Giving greater insight into the auditor's assessment of the quality of an entity's internal controls informing their significant risk assessment;
- Being more explicit about the auditor's view on the appropriateness of management estimates.
- Greater transparency about assumptions made by management and the benchmarks used by auditors in making key judgements (although the FRC observed that this has to be balanced against the potentially competing demands for auditor's reports to demonstrate clarity and conciseness, as well as preserving the importance of reaching an overall true and fair opinion).

There is also a welcome trend on the part of investment analysts in paying greater attention to enhanced audit reports. For example, the comprehensive analysis provided on the first wave of reports by Citi Research in 2014³ was much read in the investment community who found the detail in relation to the robustness of assumptions on materiality and other aspects to be very helpful. The Investor Association instituted annual auditor awards in 2014 with various categories including the best disclosures on materiality, audit scope and the risk of material misstatement and the best report overall.

So much for the claims but what about the benefits? Academic research to date has found it hard to quantify the impact of extended audit reports. One study (Lennox et al 2015 and subsequently 2017) reported that the additional disclosures were not incrementally important to the market, but also did not increase audit fees. Another (Reid et al 2015) showed that disclosures positively affected audit quality and increased audit fees only marginally. The evidence they used suggests that

² FRC Report: March 2015 Extended auditor's reports – A review of experience in the first year.

FRC Report: January 2016 Extended auditor's reports – A further review of experience.

³ New UK Auditor's Report Update: Findings from the FTSE 100 New Auditor's Reports, Citi Research, Western Europe, 3 September 2014, and New UK Auditor's Reports: A Review of the New Information, Citi Research, Western Europe, 27 March 2014

the relative impact is greater for companies where there is limited analyst coverage, and that these reports may be addressing an information deficit. The third (Gutierrez et al 2015 and subsequently 2016) reported no effect on audit quality and an association between audit fees and the number of risks identified by the auditor.⁴

Reid et al (2015) however found that: 'Abnormal trading volume significantly increased following the implementation of the new [auditor and audit committee report] disclosure regime ... Overall, it appears that additional required disclosures from audit committees and auditors provide useful information to investors.'⁵ Admittedly the data only covers a short period as the reporting regime is still in its early stages and it is probably necessary to wait for a longer time frame to draw more definitive conclusions.

Extended auditor reporting has been in place for about 5 years in the UK with significant support from both the audit profession and the investment community if not companies themselves. It is no coincidence that the UK has a well developed corporate governance regime and in parallel with the extended audit report requirement introduced an obligation on Audit Committees to report on significant audit issues. The IAASB model is now being applied internationally with varying outcomes and the PCAOB version has yet to be fully implemented in the USA.

However, it is not a given that the relative success seen in the UK in narrowing the audit expectations gap will be sustained or mirrored elsewhere. There is an obvious danger that the extended audit report could retreat into boilerplate disclosure of limited value. To build on the achievements of extended auditor reporting in the UK and implement and maintain it successfully around the world will require commitment from companies, auditors,

investors, regulators and other stakeholders. Nevertheless, as recently as ten years ago, the idea of disclosing in the auditor's report the key decisions and findings of the audit would have seemed implausible. The stakes are high and the race is still only in its early stages but the prize is well worth pursuing.

Further Reading

ICAEW Extended audit reports: Exploring challenges and opportunities in implementation, May 2016

ICAEW The Start of a Conversation – The Extended Audit Report, August 2017

⁴Bedard et al - Does recent academic research support changes to auditor reporting standards? Jan 16 Accounting Horizons p263

⁵Reid, Carcello, Li & Neal: July 2015 p.25 – Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom