Changes to communication and reporting for companies and auditors: what do companies and auditors need to start thinking about?

May 2013
Recent changes to auditing standards on communication and reporting arising directly from revisions to the UK Corporate Governance Code will require companies to work with their auditor to implement the changes effectively.

Background

In conjunction with issuing the Revised UK Corporate Governance Code (the Code) and the Revised Guidance on Audit Committees, the UK’s Financial Reporting Council (FRC) issued the following revised International Standards on Auditing (UK and Ireland) (ISAs):

- ISA 260 Communication with those charged with governance
- ISA 700 The auditor’s report on financial statements (Revised)
- ISA 720A The auditor’s responsibilities relating to other information in documents containing audited financial statements.

The changes should therefore be viewed in the context of changes in related areas, including:

- The broader revisions to the Code including, on audit tendering, diversity and board evaluations
- The FRC’s finalisation of its proposals to make audit reports more informative by including information about materiality, audit scope and audit risks
- The FRC’s finalisation of its Going Concern Guidance to implement the recommendations of the Sharman Panel (intended to replace the Guidance it issued in 2009)
- The Department of Business, Innovation and Skills finalisation of narrative reporting and remuneration reporting regulations
- The consideration by the FRC of its Internal Control Guidance for Directors (previously the Turnbull Guidance) later this year.

What are the new requirements under the revised ISAs and the related Code revisions?

For companies, two key changes in Section C: Accountability of the Code are for the:

i. Board to confirm 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 performance, business model and strategy.

ii. Audit committee to provide information to shareholders (within a separate section of the annual report and accounts) on the significant matters it considered in relation to the financial statements (including matters communicated by the auditor) and how these matters were addressed.

In line with these changes, there are enhanced auditor communication and extended auditor reporting requirements.

These are intended primarily to create greater transparency about the judgements made by management and auditors in the course of preparing and auditing financial statements. Further details of the changes are provided in Appendix A.

What are the reasons for the changes?

The changes emanate from the FRC’s Effective Company Stewardship Initiative. The FRC believes that it is vital that boards (and ultimately shareholders) receive improved reporting and communication from their auditors to assist them in fulfilling their stewardship obligations.

What is the impact of these changes and when do they take effect?

Auditors of companies subject to (or that voluntarily apply) the Code will have to communicate and report under these revised ISAs for any period commencing on or after 1 October 2012.

In order to implement the changes smoothly and efficiently, it is vital that companies also play their part as auditor reporting is entirely dependent on how companies deal with the relevant changes arising from the Code.

Over the course of the next year, companies and auditors will have to deal with these and other changes that are occurring in corporate reporting, corporate governance and auditor reporting.

Whilst this paper concentrates on the changes resulting from the revised ISAs and the related changes in the Code, it should be recognised that they come at a time of a major overhaul to UK corporate governance, corporate reporting and auditor reporting.

1 Whilst not addressed in this paper, the audit committee’s report will also have to provide information in relation to the effectiveness of the audit process, auditor independence and auditor tenure and appointment.
Practical considerations

In order to implement the changes, there are certain practical implementation aspects that need to be considered now with regard to:

► Communication protocols between management, boards, audit committees, auditors and others within the company, e.g., internal audit and risk functions.

► Reporting processes and timetables within companies

► The audit committee’s report within the annual report and accounts

The extent of the changes required to communication and reporting will vary from company to company and will depend on: what is currently communicated by auditors to audit committees, by management to audit committees; and what disclosure is currently contained in the annual report and accounts.

The remainder of this paper sets out some questions that boards, audit committees and auditors should consider and debate as they implement the changes.
1. Fair, balanced and understandable

A Principle of the 2010 Code was for the board to ‘present a balanced and understandable assessment of the company’s position and prospects’. Additionally the Disclosure and Transparency Rules of the Financial Conduct Authority require that the management report contains a ‘fair review of the company’s business’.

Therefore in practical terms what will be different? The new requirement covers the entire annual report and accounts, rather than just the narrative in the front half of the annual report.

Defining what ‘fair, balanced and understandable’ means

► What does ‘fair, balanced and understandable’ mean to the board, the audit committee, the auditor and the company’s stakeholders?

► Has the company canvassed views from users and other stakeholders on whether or how the company’s annual report and accounts will need to change to make it ‘fair, balanced and understandable’ and to provide them with the information they need to assess the company’s performance, business model and strategy (‘relevant information’)?

► In light of the new requirement, has the company recently revisited the FRC’s publications: Louder than Words, Cutting Clutter and the FRRP Annual Report 2012 to consider whether any guidance contained in these publications will help make the annual report and accounts ‘fair, balanced and understandable’?

Process

► In relation to the requirement for the board to confirm that the annual report and accounts is ‘fair, balanced and understandable’, what processes has the board put in place to bring ‘relevant information’ to the attention of those directly responsible for preparing the annual report and accounts and for making the statement?

► Has the board and audit committee discussed what information they may find useful to obtain from the auditor to help fulfil their respective obligations under C1.1 and C3.4 of the Code to ensure that the annual report and accounts taken as a whole, is ‘fair, balanced and understandable’?

Levels of assurance

► What assurance is currently provided to the board and the audit committee in respect of the annual report (other than the financial statements)?

► Is more assurance required? If yes, what form does such assurance take and what arrangements need to be put in place to obtain it?

► Does the board intend to give the audit committee a formal role in assessing whether, taken as a whole, the annual report and accounts is ‘fair, balanced and understandable’?

A good time to start thinking about the practical impact of these changes is the debriefing meetings reflecting on the current year’s audit process and annual report and accounts; which for many companies will be taking place now or over the next few weeks.

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2 Main Principles Section C: Accountability

3 The Financial Services Authority until 1 April 2013.

4 DTR 4.1.8.

5 C1.1: the directors’ duty to state that they consider 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 performance, business model and strategy; C3.4: the audit committee’s duty to provide advice (if requested by the board) on the statement made by the board under C1.1
2. Significant issues considered by the audit committee in relation to the financial statements

IFRS already requires disclosure of critical accounting policies, estimates and judgements, so what is different?

The audit committee now has to disclose, within the annual report and accounts, the significant issues it considered in relation to the financial statements, including those communicated by the auditor, and how they were addressed.

Such information should help shareholders and other users to understand the audit committee’s governance and oversight role in addressing such matters.

**Disclosure of significant matters in relation to the financial statements – current state vs. future state**

- What disclosure does the annual report and accounts currently contain (either within the audit committee’s report or elsewhere) on significant judgements and estimates in relation to the financial statements?
- In view of the auditor’s current communication to the audit committee on significant audit and accounting issues (including judgements and estimates) what further information does the audit committee feel it needs in relation to significant judgements made during the course of the audit to help it fulfil its responsibilities under C3.2\(^6\) of the Code?
- Would the audit committee like to be informed of decisions made by management and potentially agreed by auditors during the course of the year (and hence ‘embedded’ in the financial statements)? If yes, what criteria do these decisions need to meet?
- If this disclosure requirement applied in the last financial period, how would the audit committee have amended its report (in the annual report and accounts) in light of the audit and accounting issues that the auditor communicated for the most recently concluded year-end audit?
- Given the auditor’s current communication of internal control related matters (including significant deficiencies), what would the audit committee consider useful by way of views on internal control systems to help discharge the audit committee’s responsibility under Code provision C2.1?\(^7\)
- Do the board and the audit committee have a shared view of information which would be prejudicial to the interests of the company if disclosed?\(^8\)
- What are the expectations of an informed shareholder or regulator on what the company should be disclosing in terms of the significant issues the audit committee considered in relation to the financial statements and how they were addressed?
- Has the company considered participating in the Financial Reporting Lab’s project on audit committee reporting? This may help the audit committee gain early insights into approaches to audit committee reporting from the perspectives of other companies as well as investors.

**Process and timetables**

- Given the audit committee’s report in the annual report and accounts will need to include matters communicated by the auditor, what is the impact from a timing perspective of when the auditor communicates such matters to the audit committee vs. when the audit committee report is written and finalised?
- Are changes needed to the audit process and audit communication protocols, e.g., consideration of a ‘hard close’ to provide early warning of issues that are likely to be included in the auditor’s communication to the audit committee/board?
- What is the impact, if any, on the year-end financial close process including timetables for audit committee and board meetings, audit conclusion and accounts finalisation and approval?
- How will the board and audit committee deal with the potential implications of an increased disclosure of issues which may have arisen from the external audit, including potential questions/challenges from investors?
- Do management and the audit committee need to revisit/re-think what information (and the criteria for this information) the auditor currently reports to the audit committees?
- Who currently writes the audit committee section within the annual report? Does this need to be re-considered in light of the changes?

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\(^6\) In summary Code provision C3.2 covers the audit committee’s responsibilities over financial reporting, internal control and external audit

\(^7\) C2.1: the board’s duty to conduct a review of the effectiveness of the company’s risk management and internal control systems at least annually and to report to shareholders that they have done so.

\(^8\) 5.4 of the Guidance on Audit Committees states that when reporting on significant issues, the audit committee would not be expected to disclose information which, in its opinion, would be prejudicial to the interests of the company (for example because it related to impending developments or matters in the course of negotiation).
Concluding remarks

Any changes made to reporting and communication both by auditors and companies must be put in the context of the origins for these changes, i.e., the FRC’s Effective Company Stewardship Initiative.

Companies must take a step back and consider whether the changes they make to their reporting transparently and clearly articulate for users and stakeholders:

► The activities of the business, any associated risks and how they are managed.
► The judgements made by management and auditors in the course of preparing and auditing the financial statements.
► The role of the audit committee in ensuring the integrity of the annual report and accounts and in the effectiveness of the audit process.

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Helpful information and links

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<td>Will provide more context for these changes.</td>
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<td>FRC’s Cutting Clutter Report and Louder than Words Report</td>
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<td>Will provide helpful tips on making reports and accounts fair, balanced and understandable.</td>
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<td>Contains an aide memoire for boards highlighting the characteristics of what makes good corporate reporting.</td>
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<td>Consider participating to get early insights on how audit committee reporting may change.</td>
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<td>► Revised ISAs (UK&amp;I), including feedback statements</td>
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Appendix A  The detail

1. Relevant changes in the UK Corporate Governance Code

Under C1.1, directors are required to 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.

An important addition to C3.2 is that the audit committee is now required to report to the board on how it has discharged its responsibilities.

Under C3.8, the audit committee’s report within the annual report and accounts should describe the work of the committee in discharging its responsibilities and should include:

► The significant issues it considered in relation to the financial statements (including matters communicated by the auditor) and how these were addressed.
► An explanation of how it has addressed the effectiveness of the external audit process; the approach taken when they took or re-appointed the external auditor; information on the length of tenure of the current audit firm and when a tender was last conducted.
► An explanation of how auditor objectivity and independence is safeguarded if the external auditor provides non-audit services.

2. Revisions to the auditing standards

Under the revised communication standard (ISA 260) the auditor will be required to communicate to the audit committee:

► Information that the auditor believes the board and audit committee will need in the context of fulfilling their respective responsibilities under certain provisions of the UK Corporate Governance Code, namely C1.1, C2.1, C3.4.
► Information that is relevant to the audit committee (in the context of fulfilling its responsibilities under Code provision C3.2) in order to understand the significant professional judgments (including the rationale for these and the supporting evidence relied on in making them) made in the audit and reaching the audit opinion.

If not already covered by other communication from the auditor (i.e., on planning matters or significant findings from the audit) this communication shall include the auditor’s views on:

► Business risks relevant to financial reporting objectives, the application of materiality and the implications of the auditor’s judgments in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified.
► Significant accounting policies (both individually and in aggregate).
► Management’s valuations of the entity’s material assets and liabilities and the related disclosures provided by management.
► The entity’s internal control system based on their audit work (without expressing an opinion on the effectiveness of the entity’s internal control).
► Other risks arising from the entity’s business model and the effectiveness of related internal controls to the extent, if any, the auditor has obtained an understanding of these matters.

Under the enhanced auditor reporting standards (ISA 700 and 720), the auditor will be required to report by exception, if:

a. The board’s statement 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 performance, business model and strategy is inconsistent with the knowledge acquired during the audit.

b. The section within the annual report and accounts describing the work of the audit committee does not appropriately address matters communicated by the auditor to the committee.

c. The explanation as to why the annual report does not include the statement in a) or the section in b) is materially inconsistent with the knowledge acquired during the course of the audit.

d. When reading other information included in the annual report, the auditor has identified any information that is materially inconsistent with the audited financial statements or contains a material misstatement of fact or is apparently materially incorrect/inconsistent based on the knowledge acquired by the auditor in the course of performing the audit or otherwise misleading.

5 This disclosure was also required under C3.7 of the 2010 Code.
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