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# The expanded auditor's report: A case study from the United Kingdom

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The Expanded Auditor's Report: A Case Study From the United Kingdom

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An Honors College Project Presented to  
the Faculty of the Undergraduate  
College of Business  
James Madison University

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by Maria Elisa Colleen Jones

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Accepted by the faculty of the Department of Accounting, James Madison University, in partial fulfillment of the requirements for the Honors College.

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PUBLIC PRESENTATION

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## **II. Acknowledgments**

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### **III. Introduction**

In the United States, publicly-held companies are required to present their financial statements according to a set of accounting standards and rules known as Generally Accepted Accounting Principles, or GAAP. A company's management has responsibility for preparing the company's financial statements. The role of independent certified public accountants, auditors, is to audit the financial statements and render an opinion as to whether the financial statements are fairly stated and comply in all material respects with GAAP. The auditor's report, which communicates the auditor's opinion, has been criticized for being a pass/fail report that has little communicative value (PCAOB Open Board Meeting, 2016).

The Public Company Accounting Oversight Board (PCAOB), which sets standards for audit procedures and reporting practices, regulates auditors of publicly-held companies. The PCAOB is currently considering a proposal to expand the auditor's report from the standardized one page report to a more in-depth discussion by the auditor about matters that pertain directly to the company. The expansion would remedy the formulaic language of audit reports, introduce critical audit matters (CAMs) in the report, and require the auditor to disclose his or her tenure in the report (PCAOB Open Board Meeting, 2016).

The PCAOB proposal comes at a relevant time because the United Kingdom recently adopted an expanded auditor's report. In 2013, the Financial Reporting Council of the United Kingdom (FRC) adopted new standards for the auditor's report in the UK. The change in standards came in response to the financial crisis of 2007-2008, which left investors feeling blindsided by numerous bankruptcies where audits were seen to fail to give warning of imminent collapse (House of Lords, 2011). The new reports in the UK allow auditors to take a more free-form approach to writing the auditor's report, thus doing away

with formulaic language (PCAOB White Paper, 2016). The new standard also requires auditors to identify key audit matters and to report risks of material misstatement, as well as describe how the audit scope addressed those risks. For the remainder of the paper, the term CAMs will be used to describe both key audit matters (the term adopted in the UK) and critical audit matters (the term proposed in the US).

This paper will examine whether the expanded auditor's reports provide additional information beyond what management discusses in Management Discussion and Analysis and footnotes to the financial statements by performing a qualitative analysis of the information provided in the expanded auditor's reports of four major UK grocery store chains both before and after the adoption of the new standard. This paper also examines whether the reported CAMs change from year to year. The results of the paper should be useful to policymakers in the US as they decide whether or not to adopt an expanded auditor's report similar to the one now required in the UK. In my analysis I find that the external auditor is frequently reporting on CAMs that are already being reported by management, and therefore already communicated to investors, suggesting little to no added value in the expanded auditor's report. However, it also may suggest that what the auditor reports influences what management reports, which could provide added value for investors.

In the next section, I review the history of audit reporting standards in the US and the UK, explain the PCAOB proposal, and survey academic research on this subject. In the sections following the introduction, I will explain the procedures and results of my qualitative analysis.

## IV. Background

### **A. History**

In the 1800s audit reports were extremely brief, often 50 words or fewer (Chalmers, et al., 2015). This audit report was often referred to as a certificate, wherein the auditor certified some level of fairness, trueness, or correctness of the financial statements (Church, et al., 2008). These reports were generally non-standardized, and investors were left to their own devices to determine the level of assurance provided by the auditor (Brown, et al.). The auditor's report saw its first element of standardization in 1934 when the New York Stock Exchange issued regulations requiring audit reports to include a scope and an opinion paragraph (Brown, et al.). The scope paragraph explained what the audit entailed and the opinion stated whether the company followed generally established accounting principles (Church, et al., 2008). Standardization was meant to aid users in identifying non-standard audit reports (Brown, et al.). The phrase "generally accepted accounting principles" (GAAP) was introduced for the first time in 1939 (Geiger, 1993).

For the next 60 years, the auditor's report was essentially unchanged, with minor exceptions. During this period, changes to the auditor's report focused mainly on the wording of the reports, as well as guidance on reporting on non-standard issues (Brown, et al.). The wording of the reports expanded to include explanations of the audit process, as well as explicit recognition of the auditor's reporting responsibilities (Church, et al., 2008). Standard reports received an unqualified opinion, meaning no material errors were detected by the audit. Non-standard reports included qualified opinions, meaning isolated material errors exist in the financial statements; disclaimers of opinion, meaning the auditor gave no opinion because the audit lacked enough evidence; and adverse opinions, meaning the



auditor identified multiple or significant material errors or misstatements, which are rare because auditors generally communicate large errors to management to correct so that they can then issue an unqualified or qualified opinion (Church, et al., 2008).

Accounting scandals in the early 2000s, such as Enron and WorldCom, caused investors to lose trust in auditors and in the credibility of the auditor's report. As a result, Congress passed the Sarbanes-Oxley Act of 2002, which in turn created the PCAOB, and further standardized the auditor's report. The new standards required auditors to give an opinion on both the fairness of the financial statements and on internal control over financial reporting, including a description of any identified material weaknesses (Church, et al., 2008). Critics argued that the enhanced structure of the auditor's report changed the nature of what the auditor's report stands for (Church, et al., 2008). Although the auditor's report is meant to be a communication tool, the emphasis on standard language caused the auditor's report to transform into a symbol of the auditor's work or reputation, as opposed to an informative document for users of financial statements (Church, et al., 2008). As a result, there have been requests in recent years for the PCAOB to reexamine the purpose of the auditor's report and how it can be used to communicate more effectively to investors.

The auditor's report in the United Kingdom followed a similar trajectory to that of the US, until recently. The rule-making body in the UK is the Financial Reporting Council, or FRC. Whereas the PCAOB issues Auditing Standards, commonly referred to as AS's, the FRC issues International Standards on Auditing, or ISAs. The ISA that is of particular interest is ISA (UK) 700 because this is the standard that expanded the auditor's report in the UK as of 2013. Another standard-setting board, the International Auditing and Assurance Standards Board, or IAASB, also issues ISAs, which explains why "UK" is in parentheses for those ISAs issued by the FRC. However, I will refer to the UK standard,

ISA (UK) 700, as ISA 700 for simplicity. Throughout my analysis, I refer to the years prior to and including 2013, before the expanded auditor's report was included in annual reports, as the pre-ISA 700 period. The post-ISA 700 period refers to the years after 2013, when the expanded auditor's report came into practice.

ISA 700 dramatically changes the auditor's report in a few key ways. First, it allows the auditor to take a more free-form approach to writing the report, as opposed to following a standard outline. Second, it requires auditors to explicitly identify CAMs and risks of material misstatement. Third, it requires auditors to describe how the scope of the audit and the determined level of materiality addressed CAMs and risks of material misstatement (Financial Reporting Council, June, 2016). In a summary analysis regarding the evolution of the auditor's report published by PricewaterhouseCoopers, an accounting firm that provides auditing services throughout the world including the UK, the authors succinctly describe some of their perceived benefits of the expanded auditor's report:

“Our opinion is now less than a tenth of the overall report. We now describe the risks of material misstatement that had the greatest effect on our audit and how we addressed those risks. We highlight where we performed our work, and why, both from a geographic and company structure perspective. We describe the materiality we used to help us determine the scope of our audit and to evaluate misstatements.”

An important element of the expanded report is that because auditors can write freely about specific events and circumstances in both the macro and micro environment affecting the company in the year under audit, stakeholders can more easily determine the identity of the company – even if the name of the company were to be covered up (Chalmers, et al., 2015). The authors shared with readers that “some shareholders have told [them] that the audit report is the *first* thing they turn to in the Annual Report (Chalmers, et al., 2015).” This speaks to the value of the audit report to shareholders, investors, and other users, and to the credibility of the auditor's opinion.

In January 2016 the FRC released a report reviewing the successes and shortcomings of the expanded auditor's report thus far. In the summary for investors, the FRC reports auditors have succeeded in moving away from "generic language and descriptions of risk, making their reports more relevant and insightful (Financial Reporting Council, January, 2017)." Investors especially appreciate the ease of following the new structure, due to the deliberate use of signposting, graphics, diagrams and color. However, investors still have requests for what they see lacking in the reports, including more information about sensitivity ranges used in audit testing; greater insight into the auditor's assessment of internal controls; and explicitness about the auditor's view on the appropriateness of management estimates (Financial Reporting Council, January, 2017). Overall, it appears that there was some value added – at least in the appearance and the ease of reading the auditor's report – yet investors are still lacking some of the information that they were hoping to receive.

## **B. PCAOB Proposal**

In response to concerns of investors and other financial statement users that the auditor's report could be more informative and a better communicative tool, the PCAOB began outreach in 2010 on possible changes to the auditor's report (PCAOB Release 2011-003, June 21, 2011). This effort led to a Concept Release in 2011, followed by the issuance of a Proposed Rule in 2013 and a Reproposed Rule in 2016. As of March 2017, the PCAOB is drafting a release for Board action. This section and Exhibit 1 outline the timeline and main points of the PCAOB's standard-setting project on the auditor's reporting model.

On June 21, 2011 the PCAOB issued a Concept Release to address alternatives for changing the auditor's reporting model. The Concept Release came in response to concerns

of investors and other financial statement users that the auditor's report could be more informative and generally a better communicative tool than it is currently (PCAOB Release 2011-003, June 21, 2011). The Concept Release presented a number of alternatives for investors, financial statement preparers, auditors, audit committee members, and others to respond to with comments and questions, in order for the PCAOB to develop a formal proposal (PCAOB Release 2011-003, June 21, 2011). Among the alternatives discussed in the Concept Release were the addition of an Auditor's Discussion and Analysis; required use of emphasis paragraphs; auditor reporting on information outside the financial statements; and clarification of certain language in the auditor's report (PCAOB Release 2011-003, June 21, 2011). The Concept Release was used to solicit public comment about the alternatives, as well as to invite interested parties to join a public roundtable, held on September 15, 2011, to discuss the alternatives (PCAOB Release 2011-003, June 21, 2011).

Following the Concept Release, roundtable, and solicitation of comments, the PCAOB released the first version of the Proposed Rule on August 13, 2013. This proposal explains that investors believe that auditors gain knowledge during the audit that is not known to investors that might assist them in making investment decisions (PCAOB Release 2013-005, August 13, 2013). The PCAOB goes on to explain that the auditor's report has remained largely unchanged in the U.S. since the 1940s, yet the report is undergoing change globally (PCAOB Release 2013-005, August 13, 2013). This first version of the proposal included three significant changes to the existing auditor's report, including reporting critical audit matters; adding elements related to auditor independence, tenure, and responsibilities for other information; and enhancing certain standardized language (PCAOB Release 2013-005, August 13, 2013). These proposed standards are meant to increase the informational value of the auditor's report without placing an undue burden on the financial reporting

process (PCAOB Release 2013-005, August 13, 2013). Following the release of this initial proposal, the PCAOB hosted Standing Advisory Group meetings, Investor Advisory Group meetings, and a public meeting on the auditor's reporting model between November of 2013 and October of 2014 to invite further comments and prepare revisions for the proposed rule (PCAOB Release 2013-005, August 13, 2013).

In response to the meetings and additional commentary from investors, financial statement preparers, auditors, audit committee members, and other users of financial statements, the PCAOB released a Reproposed Rule on May 11, 2016. Although this latest proposal retains the pass/fail nature of the auditor's report, it introduces significant changes as well (PCAOB Release 2016-003, May 11, 2016). These changes include (1) determining, communicating, and documenting critical audit matters; (2) clarifying the auditor's role and responsibilities, specifically with regards to independence, tenure, and addressee; (3) adding explanatory language and emphasis paragraphs; (4) including information about certain audit participants; and (5) clarifying the form of the auditor's report (PCAOB Release 2016-003, May 11, 2016).

The first element of the reproposal related to critical audit matters (CAMs) required the most attention, particularly with regards to defining a CAM because the definition changed moderately from the 2013 proposal (PCAOB Release 2016-003, May 11, 2016). CAMs are defined as those matters that were communicated or were required to be communicated to the audit committee; that relate to accounts or disclosures that are material to the financial statements; and that involved especially challenging, subjective, or complex auditor judgment (PCAOB Release 2016-003, May 11, 2016).

The second element which clarifies the auditor's role and responsibilities includes the addition of an independence statement to enhance financial statement users' understanding

of the auditor's existing obligation to be independent, and serves as a reminder to the auditor of this obligation (PCAOB Release 2016-003, May 11, 2016). Further, the PCAOB proposes to make it uniform that the auditor addresses shareholders and the board of directors, with the option to include other addressees (PCAOB Release 2016-003, May 11, 2016). In addition, the PCAOB proposes that auditor tenure be disclosed. However, the Board is also seeking comment on whether auditor tenure would be more appropriate on the recently adopted Form AP, *Auditor Reporting of Certain Audit Participants* (PCAOB Release 2016-003, May 11, 2016).

The third element of the repropoed standard provides examples of potential matters that the auditor may choose to emphasize in the auditor's report. These additional emphasis paragraphs may be used when there is substantial doubt about the company's ability to continue as a going concern or in the event of a restatement of previously issued financial statements (PCAOB Release 2016-003, May 11, 2016). The auditor may also decide to emphasize other matters in the financial statements or use additional explanatory language if the auditor determines it is appropriate to do so.

The fourth element of inclusion of information about certain audit participants is optional under the repropoed standard (PCAOB Release 2016-003, May 11, 2016). The purpose of this element is to incorporate a new Securities and Exchange Commission (SEC) amendment that requires firms to disclose engagement partners and other accounting firms on Form AP, with the choice of also disclosing this information in the auditor's report (PCAOB Release 2016-003, May 11, 2016). The repropoed standard does not include a specific location for this disclosure (PCAOB Release 2016-003, May 11, 2016).

Finally, the fifth element related to the form of the auditor's report offers auditors more flexibility in presentation (PCAOB Release 2016-003, May 11, 2016). The repropoed

rule would require the “Opinion on the Financial Statements” section to be the first section of the auditor's report, immediately followed by the “Basis for Opinion” section, but the other sections – including CAMs and explanatory paragraphs – would have no specific order (PCAOB Release 2016-003, May 11, 2016).

### **C. Academic Research**

Various researchers have come to a number of conclusions about whether or not the expanded auditor's report is more informative than reports of the past. Marcus M. Doxey found that auditor disclosures regarding management estimates increase the transparency and value-relevance of the audit report (Doxey, 2014). Doxey used MBA students from a major land-grant university in the US as participants in the experiment. In Doxey's experiment he gave participants auditor's reports for different companies, all of which received unqualified opinions (passing assessments), and asked them to decide how much they would invest in each company. He found that participants' evaluation of management was generally intuitive, whereas evaluation of auditor independence was unintuitive. Participants reduced their investments in companies in which they perceived aggressive reporting choices by management, such as those related to estimates. This is intuitive because participants may suspect that aggressive reporting choices indicate management bias or attempted earnings management, so they are unlikely to find those choices reliable.

However, subjects rated auditors who agreed with management as more independent than those who publicly disagree (Doxey, 2014). Standard-setters may anticipate the opposite to happen – that auditors who *disagree* with management would be seen as more independent – but given an unqualified opinion, disagreement seems to violate users'

expectations of the auditor's view of the fairness of the financial statements. Some auditors have voiced concern that users may misinterpret additions to an expanded auditor's report, and Doxey's finding may support that concern. However, Doxey also found that expanding audit disclosures to include the auditor's views on estimates actually reduces user's views of the level of assurance provided by an audit. Often users believe an audit provides absolute assurance when in fact auditors are required only to provide reasonable assurance (Louwers, et al., 2015). This finding suggests that an expanded report adds value in that it reduces the expectations gap and clarifies the position of the auditor.

Lennox, Schmidt, and Thompson also tackle the question of whether the expanded UK audit report is more informative to users. Consistent with my hypothesis of US reporting, they find that in prior annual reports management has already disclosed many risks of material misstatement (RMMs) that the auditor is now required to report as CAMs (Lennox, et al., 2016). The researchers found that only 20% of the auditor risk disclosures were potentially new in the first year of the expanded report. They add that many times management is disclosing these risks outside of the annual reports, such as through conference calls. Additionally, they find that users do not find these disclosures to be incrementally informative. Market reactions were insignificant for small companies, companies with low analyst followings, and companies with low ownership by large shareholders (Lennox, et al., 2016).

Another concern with the additional risk disclosures is that the RMMs reported by the auditor may have been relevant to the interim financial statements, yet are irrelevant to the audited financial statements. This could explain why market reactions are insignificant or why investors do not find the disclosures to be incrementally informative, either because the RMMs were eliminated during the audit by performing extended audit procedures or



because investors already knew about the risks before the expanded auditor reports were introduced (Lennox, et al., 2016). However, it can be argued that disclosure by an auditor is more credible than disclosure by management, thus adding value to the risk disclosures (Lennox, et al., 2016).

Smith also found little evidence that markets had an observable response to the introduction of the expanded audit reports, although she found that the readability and the tone of the reports changed. Other researchers rated audit reports in the pre-ISA 700 period to be “very difficult” and even “inhibitive” in effectively communicating audit results to financial statement users (Smith, 2016). On the FOG scale<sup>1</sup> that Smith uses, audit reports required more years of formal education for user comprehension than Form 10-Ks and Wall Street Journal articles. However, in the post-ISA 700 period users require five fewer years of formal education to comprehend the reports as compared to comprehending the pre-ISA 700 reports (Smith, 2016). These findings suggest that expanded audit reports are more accessible to users because the language has changed in a way that makes them easier to read, suggesting that boilerplate language is indeed changing.

As for tone, Smith found the post-ISA 700 reports to include more negative words, which could be explained by auditors disclosing more RMMs and detailing the impact of those risks on the scope of the audit. Additionally, she found that there was a higher rate of all tone related words (positive, negative, and uncertain), suggesting that additional disclosures were not standard in nature but in fact potentially added value to the reports (Smith, 2016).

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<sup>1</sup> The Fog Index (*FOG*) is a widely used readability statistic developed by Robert Gunning (Gunning, 1952) that evaluates the number of words in a sentence and the percentage of complex words (words with three syllables or more) to estimate the number of formal years of education an average person would need to read and comprehend the text. The higher the measure the more complex the text.

Gimbar, Hansen, and Ozlanski examine the potential of the proposal to increase auditor liability and subsequent litigation (Gimbar, et al., December 2015). They review five experiments that address this question and identify patterns in the research. They differentiate between related CAMs (those that specifically relate to litigated issues) and unrelated CAMs (those that discuss high-risk accounting issues that are different from the accounting issues identified in litigation). Although they identify a variety of conclusions among the five experiments, preliminary evidence indicates that legal liability is either reduced or unchanged when a related CAM is included in the audit report, subject to two notable exceptions. First, a related CAM for which audit procedures are also described in the report tends to increase perception of auditor liability, as well as foreseeability of the misstatement (Backof, 2014). Second, a CAM is associated with higher perception of auditor liability when the related accounting standard is precise (rules-based) as opposed to less precise (principles-based) (Gimbar, et al., August 2015).

Gimbar, et al. note that the results about unrelated CAMs are mixed and less conclusive than the results for related CAMs (Gimbar, et al., December 2015). Because unrelated CAMs do not serve as disclaimers in the way that related CAMs do, some experiments concluded that they increased perception of auditor liability (Gimbar, et al., December 2015). However, other researchers found that inclusion of a CAM had no effect on this perception, and one experiment found that an unrelated CAM actually reduced the perception of auditor liability when compared to situations where the auditor explicitly disclosed that no CAMs were identified in the audit (Brasel, et al.). Gimbar, et al. noted some limitations with their examination of the five experiments, including the fact that the experiments engage four different participant pools, which could explain much of the variation in results (Gimbar, et al., December 2015). In addition, they raise the questions of

how precision of the audit standards influences auditor liability perception, and whether clarifying language about the audit procedures could interact with CAM disclosures (Gimbar, et al., December 2015).

In a second paper, Gimbar, Hansen, and Ozlanski perform their own experiment related to the similarities between imprecise standards and CAMs (Gimbar, et al., August 2015). Using students enrolled in introductory accounting courses to model jurors, they introduce a scenario in which “a large pension fund investor alleges that the auditor allowed the company’s equipment leases to be inappropriately classified as operating instead of capital.” They note that “lease classification is an ideal setting in which to examine precise and imprecise standards, as bright-line thresholds exist in the precise environment, while judgment is more clearly required when imprecise standards are applied.”

They find that imprecise standards require greater auditor judgment and skill and therefore increase auditor liability, whereas precise standards constrain auditor control over financial reporting outcomes and therefore decrease auditor liability (Gimbar, et al., August 2015). However, when a related CAM is disclosed under precise standards jurors perceive auditors to have a causal role in and an ability to foresee an audit failure because like imprecise standards, related CAMs require greater auditor judgment and skill (Gimbar, et al., August 2015). In addition they find that when an unrelated CAM is disclosed under precise standards jurors question the quality of the audit and the auditor’s intent to take the necessary actions to prevent accounting misstatement (Gimbar, et al., August 2015). Thus, both related and unrelated CAMs are increasing auditor liability in the same way that imprecise standards do, even when they are applied under precise standards (Gimbar, et al., August 2015). They argue that the results of this experiment could lead auditors to increase

the amount of audit work given the higher litigation risk, and could subsequently increase audit fees (Gimbar, et al., August 2015).

Gutierrez, Minutti-Meza, Tatum, and Vulcheva examine changes in audit fees, audit quality, and investors' reaction to the expanded auditor's report (Gutierrez, et al., 2016). As for audit fee changes, they find mixed results ranging from an increase of nearly four percent to no change in the post-ISA 700 period, depending on the specificity of the model (Gutierrez, et al., 2016). As for audit quality, they do not find evidence of change. The most striking change they identify is the length of the audit report, which triples on average from 757 words to 2,400 words (Gutierrez, et al., 2016). They also note a decrease in the incidence of including internal control issues as a risk (Gutierrez, et al., 2016). Finally for investor reaction they find little change, possibly because the additional information may not be strictly new to investors, as they may already be using other information sources (such as management discussions, financial analyst reports, and audit committee reports) to gather the same information, or they may infer certain risks based upon observable characteristics of the company, such as size or presence of intangible assets including goodwill (Gutierrez, et al., 2016). They also find in their descriptive statistics that the public release of the annual report is generally not a significant source of new information for investors, either before or after the introduction of the expanded auditor's report (Gutierrez, et al., 2016).

In conclusion, the existing research has yielded mixed results on the benefits of the expanded auditor's report. I chose to evaluate how informative the expanded report is by comparing those matters that the auditor is now reporting to matters that management already reports. In the next section, I define my research question and explain my procedure.

## **V. Research Question: Does the Expanded Report Provide New Information?**

Using annual reports from four companies in the UK, I examine whether the expanded auditor report is reporting the same risks and critical audit matters that management has already been reporting. Thus, investors will be receiving the same information in two different places. One implication of reporting the same information is that the expanded auditor report is not as valuable because it is not adding new information. One limitation is in determining whether new information added by the auditor encourages management to also mention the issue, which also makes it difficult to measure the value of the expanded report.

To examine this hypothesis, I acquired annual reports from four major grocery chains (Tesco, Sainsbury's, Marks and Spencer, and Morrison's) in the UK for the years 2010 to 2016. I specifically chose these firms because they are the only grocery chains in the UK that are publicly traded on the London Stock Exchange and primarily based in the UK. One other chain, Ocado, is also traded on the London Stock Exchange, but it is an online-only supermarket, which would make it difficult to compare to the others. I chose companies that are in the same industry because they are likely to be reporting the same or similar risks and critical matters from year to year. Thus, investors are likely to know these risks already. I chose the time range to have a sample of reports before ISA 700 (from 2010 through 2013) and after ISA 700 (from 2014 through 2016).

I went through all of the reports manually and coded the risks into three categories: (1) those reported only by management, (2) those reported only by the external auditor, and (3) those reported by both management and the external auditor. For those years prior to ISA 700 when the risks were not as easily located in the report, I typically found them

disclosed in the audit committee report or the note to the financial statements that describes “areas of significant judgment.” My conclusion is that items that fall into category three are essentially redundant – the investor is gaining the information in two different places, and he or she was likely already aware of the risk from last year’s report if management was reporting it then.

The evidence is clear that in the post-ISA 700 period, many items that were previously reported only by management are now being reported by both management and the external auditor. In the section that follows I will highlight some of these items and the trends I found in the data.

## **VI. Results**

The CAMs that I highlight below are those that three or four of the companies consistently reported from year to year. Table 1 lists the external auditor for each company for each year in the analysis. One limitation of my analysis is that PwC is the external auditor for each of the companies at one time or another. Examples of auditor’s reports in both the pre-ISA 700 period and the post-ISA 700 period can be found in Appendix A and Appendix B, respectively.

### **Capitalization and impairment of tangible and intangible assets**

As shown in Table 2, all four firms reported capitalization and impairment of tangible and intangible assets as a critical matter.<sup>2</sup> Management at three of the firms – Marks and Spencer (M&S), Sainsbury’s, and Tesco – reported it from 2010-2016. From 2014-2016

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<sup>2</sup> In some reports it was referred to simply as depreciation or amortization.

(the post-ISA 700 period) all four firms fell into category three – that both management and the external auditor were reporting the matter. For three firms, this is a great example of redundancy in the expanded auditor’s report. Not only were three out of the four firms reporting this risk in the pre-ISA 700 period, but also by the time the expanded auditor’s report was in place management and the external auditor were including it.

Interestingly, Morrison’s was using a different external auditor (KPMG) than the other three companies (all of whom used PwC) in 2014, the year in which management and the external auditor across all four firms began including the risk. In the case of the three companies whose management was reporting it in the pre-ISA 700 period, one could infer that PwC possibly picked up this CAM from management. Yet for Morrison’s, it is unclear whether the inclusion of the CAM was a result of management influencing the auditors or the auditors influencing management (or neither).

[Insert Table 2]

### **Post-retirement benefits and pension valuation**

As shown in Table 3, the four companies follow a similar pattern with reporting post-retirement benefits and pension valuation as a critical matter, again with the exception of Morrison’s. The managements of all four companies reported post-retirement benefits and pension valuation as a risk from 2010-2013 (the pre-ISA 700 period). In 2014, Morrison’s management discontinues reporting the matter. However, the managements of the remaining three firms continue to report the matter from 2014-2016 (the post-ISA 700 period). The external auditors for M&S and Sainsbury’s also reported the matter as a CAM in 2015 and 2016, and the external auditor for Tesco followed suit in 2016. Again, these are examples of redundancy between what management and the external auditor are reporting.

[Insert Table 3]

### **Internal control and risk management**

As shown in Table 4, internal control and risk management is an example of a critical matter that only began appearing in the auditor's report in the post-ISA 700 period.

However, it follows a non-uniform pattern.

In 2014, all four companies are reporting the matter somewhere. Only Morrison's management reports it, whereas only the external auditors for the other three companies report it. In 2015, the external auditors for Sainsbury's and Tesco report the matter. Morrison's and M&S do not report it at all. In 2015 M&S changed external auditors to Deloitte, which could explain why this matter disappears. In 2016, management at Morrison's reports the matter again and the external auditor for Tesco reports it. Sainsbury's and M&S do not report it at all. Interestingly, Tesco switched external auditors to Deloitte in 2016 and it continued being listed as a CAM, yet it was not for M&S in 2015. In 2016 Sainsbury's changed external auditors from PwC to EY, which could explain why this matter disappears.

This appears to be a critical matter that both management and external auditors are unsure of year to year. It is inconsistent, yet apparently still relevant, so it will be interesting to see how this issue plays out in years to come. It also raises the question of whether the choice of external auditor influences what key audit matters get reported, not only by the external auditor but also by management.

Also, this non-uniform pattern made me notice another unusual pattern related to Morrison's. Morrison's never has any risks that fall into category 2 – those items reported only by the external auditor. For Morrison's, either management reports on something or



both management and the external auditor report on it. For three out of the four risks that Morrison's external auditor includes in 2014, that is also the first year that management includes them. This suggests once more that items reported by the external auditor influence items reported by management.

[Insert Table 4]

### **Revenue recognition – refunds, loyalty schemes, and returns**

As shown in table 5, the trend for reporting revenue recognition, including refunds, loyalty schemes, and returns, as a critical matter is not as obvious as those previously mentioned. The patterns indicate that not all external auditors view this as a key audit matter each year, and management seems split on the issue as well. However, for firms who report this risk (all except Morrison's) either the external auditor is solely reporting this item or both management and the external auditor are reporting it by 2016.

Marks and Spencer has the simplest pattern, in that management reports the matter from 2010-2013, and both management and the external auditor report it from 2014-2016.

Sainsbury's is more complicated. Management only reports the matter in 2013. The external auditor, PwC, reports it in 2014, does not report it in 2015, and then their new external auditor, EY, reports it in 2016.

Tesco's management did not report the matter prior to 2015. In 2014 the external auditor included it as a CAM, and in 2015 and 2016 both management and the external auditor highlighted it.

Again, these observations support the idea that items reported by the external auditor often become items reported by management in subsequent years, and the choice of auditor can have an impact on what matters are included as CAMs.

[Insert Table 5]

### **Useful life, residual value, carrying value of PPE**

Reporting useful life, residual value, or carrying value of property, plant, and equipment (PPE) as a critical matter stood out to me because it appeared in annual reports of three of the four companies (all but Tesco), yet it was never included as a CAM by the external auditor. As shown in Table 6, Marks and Spencer reported it from 2010-2016; Morrison's reported it from 2010-2013; and Sainsbury's only reported it in 2016. This suggests that there are instances where management reports something that they feel is of high importance, regardless of whether the external auditor chooses to report it as well.

[Insert Table 6]

### **IT infrastructure and data security**

The matter of IT infrastructure and data security is interesting because the reporting patterns vary a substantial amount from firm to firm. As shown in Table 7, all firms except Marks and Spencer included it.

Sainsbury's management reported it from 2012-2015, and the external auditor reported it in 2015 and 2016. It's interesting that they overlap only in 2015 and that even though management reported it for so many consecutive years, only the external auditor reports it in 2016. This could lend credence to the idea that CAMs reported by the external auditor are more credible than those reported by management, which could cause management to cease including it.

Another interesting pattern is that Tesco's external auditor includes it in 2016, which is the first time users see it in Tesco's report. On the opposite end of the spectrum, Morrison's management reports it from 2014-2016, yet the external auditor never includes it.

These three patterns are difficult to reconcile and compare to draw conclusions.

[Insert Table 7]

### **Other trends**

Some of the risks included in the reports appeared in fewer than three of the firms, but trends are apparent and worth mentioning.

First, Morrison's and Tesco have the same pattern for onerous lease provisions and onerous property commitments, wherein management reports it from 2010-2013 (pre-ISA 700) and both management and the external auditor report it 2014-2016 (post-ISA 700).

Second, management and the external auditor specifically include inventory valuation for both Marks and Spencer (2014-2016) and Tesco (2015-2016).

Finally, Marks and Spencer and Sainsbury's have similar patterns for supply chain and supplier income accounting. Sainsbury's external auditor includes the risk in 2014, and then both management and the external auditor include it in 2015 and 2016. Marks and Spencer exhibits the same reporting pattern in 2015 and 2016.

## **VII. Discussion and Conclusion**

As I have indicated in a number of examples, management and the external auditors are frequently identifying the same risks, particularly by 2016 after ISA 700 has been in place for three years. This suggests that there is little added value in the expanded auditor's report

if users are acquiring the same information in two different locations. However, it also may suggest that what the auditor reports influences what management reports, and this is where the value may be added in that management is essentially being encouraged to report the most important matters to investors and other financial statement users. Further, there is something to be said for auditor credibility and the fact that perception of auditor independence is enhanced when auditors agree with management when giving an unqualified opinion (Doxey 2014).

This finding is important for the PCAOB to be aware of as they consider whether or not to adopt the standard for an expanded auditor's report. They must consider the costs of implementing the change if the benefits are small. So far there is not evidence in the UK that expanding the auditor's report causes audit fees to increase. In fact, auditors are already in the practice of charging higher audit fees to those clients they identify as having more risks of material misstatement (Lennox, et al., 2016).

Further research about the effect of switching auditors on the CAMs reported by management would be useful for the PCAOB in deciding whether to expand the auditor's report. From the limited data that I've compiled, it is difficult to discern major trends in this area or to draw conclusions about the level of impact an external auditor has on management's reporting choices.

It is unclear if and when the PCAOB will vote on the new standard. On December 23, 2016 one board member, Jay D. Hanson, resigned from the board, making a consensus on the vote perhaps more difficult to achieve (Hood 2016). Also, James Doty has already exceeded his term limit as chairman of the board, and the new Trump administration could appoint someone else before the PCAOB has a chance to vote (Rapoport 2016).

A major improvement in the expanded report is definitely in the ease of reading exactly which matters the auditor identifies as critical to the audit. Like the investors surveyed by the FRC, I too can attest to the fact that the signposting and diagrams are useful in understanding the content of the auditor's report, which supports Smith's finding that readability has increased. However, my analysis still shows that management consistently reports many of those same matters, so the question of added value remains.

## Exhibit 1: PCAOB Proposal Timeline

Date	Description	Main Points
June 21, 2011	Concept Release	<p>Discussion of alternatives<sup>3</sup> for changing the auditor’s reporting model:</p> <ol style="list-style-type: none"> <li>1. A supplement to the auditor’s report in which the auditor would be required to provide additional information about the audit and the company’s financial statements (“Auditor’s Discussion and Analysis”)</li> <li>2. Required and expanded use of emphasis paragraphs in the auditor’s report</li> <li>3. Auditor reporting on information outside the financial statements (e.g., non-GAAP information and earnings releases)</li> <li>4. Clarification of certain language in the auditor’s report (e.g., reasonable assurance and auditor independence)</li> </ol>
August 13, 2013	Proposed Rule	<p>Three significant changes to the existing auditor’s report:</p> <ol style="list-style-type: none"> <li>1. Auditor reporting of critical audit matters.<sup>4</sup></li> <li>2. Add new elements related to auditor independence, auditor tenure, and the auditor’s responsibility for other information in annual reports containing the audited financial statements and the related auditor’s report</li> <li>3. Enhance certain standardized language in the auditor’s report, including the addition of the phrase “whether due to error or fraud”<sup>5</sup> and the ability to include explanatory paragraphs</li> </ol>
May 11, 2016	Reproposed Rule	<p>Retains pass/fail model, but adds significant changes</p> <ol style="list-style-type: none"> <li>1. Determination, communication, and documentation of critical audit matters<sup>6</sup></li> <li>2. Clarification of existing auditor’s responsibilities (e.g., independence, tenure, addressee)</li> <li>3. Adding explanatory language and emphasis paragraphs</li> <li>4. Including information about certain audit participants (e.g., engagement partners and other accounting firms that participate in the audit)</li> <li>5. Clarifying the form of the auditor’s report</li> </ol>

<sup>3</sup> A revised auditor’s report could include one or a combination of these alternatives, elements within the alternatives or alternatives not currently presented in this concept release.

<sup>4</sup> Defined as those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements.

<sup>5</sup> This phrase is used when describing the auditor’s responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.

<sup>6</sup> Defined as those matters that (1) were communicated or required to be communicated to the audit committee; (2) relate to accounts or disclosures that are material to the financial statements; and (3) involved especially challenging, subjective, or complex auditor judgment.

**Table 1: External Auditor by Year**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer	PwC	PwC	PwC	PwC	PwC	Deloitte	Deloitte
Morrison's	KPMG	KPMG	KPMG	KPMG	KPMG	PwC	PwC
Sainsbury's	PwC	PwC	PwC	PwC	PwC	PwC	E&Y
Tesco	PwC	PwC	PwC	PwC	PwC	PwC	Deloitte

Key

<b>PwC</b>	PricewaterhouseCoopers
<b>KPMG</b>	Klynveld Peat Marwick Goerdeler
<b>Deloitte</b>	Deloitte Touche Tohmatsu Limited
<b>EY</b>	formerly Ernst and Young

**Table 2: Capitalization and impairment of tangible and intangible assets**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer							
Morrison's							
Sainsbury's							
Tesco							

Key

	Reported by management
	Reported by external auditor
	Reported by both


This table indicates whether management, the external auditor, or both were reporting capitalization and impairment of tangible and intangible assets as a key audit matter. Blank (white) boxes indicate that neither management nor the external auditor identified it as a key audit matter. Years 2010-2013 include reports prior to the expansion; years 2014-2016 include expanded auditor's reports.



**Table 3: Post-retirement benefits and pension valuation**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer							
Morrison's							
Sainsbury's							
Tesco							

Key

	Reported by management
	Reported by external auditor
	Reported by both

This table indicates whether management, the external auditor, or both were reporting post-retirement benefits and pension valuation as a key audit matter. Blank (white) boxes indicate that neither management nor the external auditor identified it as a key audit matter. Years 2010-2013 include reports prior to the expansion; years 2014-2016 include expanded auditor's reports.

**Table 4: Internal control and risk management**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer							
Morrison's							
Sainsbury's							
Tesco							

Key

	Reported by management
	Reported by external auditor
	Reported by both

This table indicates whether management, the external auditor, or both were reporting internal control and risk management as a key audit matter. Blank (white) boxes indicate that neither management nor the external auditor identified it as a key audit matter. Years 2010-2013 include reports prior to the expansion; years 2014-2016 include expanded auditor's reports.

**Table 5: Revenue recognition – refunds, loyalty schemes, and returns**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer							
Morrison's							
Sainsbury's							
Tesco							

Key

	Reported by management
	Reported by external auditor
	Reported by both

This table indicates whether management, the external auditor, or both were reporting revenue recognition, including refunds, loyalty schemes, and returns, as a key audit matter. Blank (white) boxes indicate that neither management nor the external auditor identified it as a key audit matter. Years 2010-2013 include reports prior to the expansion; years 2014-2016 include expanded auditor's reports.

**Table 6: Useful life, residual value, carrying value of PPE**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer							
Morrison's							
Sainsbury's							
Tesco							

Key

	Reported by management
	Reported by external auditor
	Reported by both

This table indicates whether management, the external auditor, or both were reporting useful life, residual value, and/or carrying value of property, plant and equipment (PPE) as a key audit matter. Blank (white) boxes indicate that neither management nor the external auditor identified it as a key audit matter. Years 2010-2013 include reports prior to the expansion; years 2014-2016 include expanded auditor's reports.

**Table 7: IT infrastructure and data security**

	2010	2011	2012	2013	2014	2015	2016
Marks and Spencer							
Morrison's							
Sainsbury's							
Tesco							

Key

	Reported by management
	Reported by external auditor
	Reported by both

This table indicates whether management, the external auditor, or both were reporting IT infrastructure and data security as a key audit matter. Blank (white) boxes indicate that neither management nor the external auditor identified it as a key audit matter. Years 2010-2013 include reports prior to the expansion; years 2014-2016 include expanded auditor's reports.

## Independent auditors' report to the members of Tesco PLC

We have audited the Group financial statements of Tesco PLC for the 53 weeks ended 28 February 2009 which comprise the Group Income Statement, the Group Balance Sheet, the Group Cash Flow Statement, the Group Statement of Recognised Income and Expense and the related notes. These Group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the Parent Company financial statements of Tesco PLC for the 53 weeks ended 28 February 2009 and on the information in the Directors' Remuneration Report that is described as having been audited.

### Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as endorsed by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Group financial statements give a true and fair view and whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Report of the Directors is consistent with the Group financial statements.

In addition we report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the Combined Code (2006) specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited Group financial statements. The other information comprises only the Introduction, the Financial highlights, Chairman's statement, Tesco at a glance, the Chief Executive's Q&A, the Report of the Directors, the Corporate governance statement, the unaudited part of the Directors' remuneration report and the Five year record. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements. Our responsibilities do not extend to any other information.

### Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Group financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Group financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Group financial statements.

### Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as endorsed by the European Union, of the state of the Group's affairs as at 28 February 2009 and of its profit and cash flows for the 53 weeks then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Report of the Directors is consistent with the Group financial statements.

### PricewaterhouseCoopers LLP

Chartered Accountants and Registered Auditors  
London 1 May 2009



To find out more go to  
[www.tesco.com/annualreport09](http://www.tesco.com/annualreport09)

## Independent auditor's report to the members of Tesco PLC

### Opinion on financial statements of Tesco 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 27 February 2016 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, including FRS 101 "Reduced Disclosure Framework"; 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 Group income statement, the Group statement of comprehensive income (loss), the Group and Parent Company balance sheets, the Group and Parent Company statements of changes in equity, the Group cash flow statement, and the related Notes 1 to 34 of the Group financial statements and Notes 1 to 17 of the Parent Company financial statements. 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), including FRS 101 "Reduced Disclosure Framework".

### Going concern and the Directors' assessment of the principal risks that would threaten the solvency or liquidity of the Group

As required by the Listing Rules we have reviewed the Directors' statement regarding the appropriateness of the going concern basis of accounting contained within the Directors' report and the Directors' statement on the longer-term viability of the Group contained within the strategic report on page 27.

- We have nothing material to add or draw attention to in relation to:
- the Directors' confirmation on page 24 that they have carried out a robust assessment of the principal risks facing the Group, including those that would threaten its business model, future performance, solvency or liquidity;
  - the disclosures on pages 24 to 27 that describe those risks and explain how they are being managed or mitigated;
  - the Directors' statement in Note 1 about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them and their identification of any material uncertainties to the Group's ability to continue to do so over a period of at least 12 months from the date of approval of the financial statements;
  - the Directors' explanation on page 27 as to how they have assessed the prospects of the Group, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

We agreed with the Directors' adoption of the going concern basis of accounting and we did not identify any such material uncertainties. 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.

### Independence

We are required to comply with the Financial Reporting Council's Ethical Standards for Auditors and we confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the prohibited non-audit services referred to in those standards.

### 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.

The Audit Committee requested that whilst not currently required under International Standards on Auditing (UK and Ireland), we include in our report any key observations in respect of these assessed risks of material misstatement, in anticipation of the EU Regulations which will require such disclosure from the Group's 2017/18 financial year.

The description of the risks below should be read in conjunction with the significant matters considered by the Audit Committee discussed on page 46.

These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

The key risks we identified are:

- store impairment review;
- recognition of commercial income;
- inventory valuation and provisions;
- pension obligation valuation and accounting for the pension curtailment;
- provisions and reserves in Tesco Bank;
- compliance with laws and regulations;
- management override of controls; and
- retail technology environment, including IT security.

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## Independent auditor's report to the members of Tesco PLC continued

Risk description	How the scope of our audit responded to the risk	Key observations
<b>Store impairment review</b>		
<p>As described in Note 1 (accounting policies) and Note 11 (property, plant and equipment), the Group held £17,900m (2014/15: £20,440m) of property, plant and equipment at 27 February 2016.</p> <p>In light of the continued competitive environment in which the Group operates, there is a risk that the carrying value of stores and related fixed assets may be higher than the recoverable amount. When a review for impairment is conducted, the recoverable amount is determined based on the higher of 'value in use' and 'fair value less costs of disposal':</p> <ul style="list-style-type: none"> <li>• value in use is calculated from cash flow projections for five years using data from the Group's internal forecasts and as such relies upon the Directors' assumptions, such as the estimates of future trading performance, longer-term growth rates and discount rates utilised; and</li> <li>• fair value less costs of disposal, reflecting the market valuation of the Group's stores less costs which would be incurred on disposal, is determined on a sample basis by independent valuation specialists where appropriate.</li> </ul> <p>As a result of the Group's impairment review completed during the year, an impairment charge of £18m (2014/15: £4,116m) was recognised.</p>	<p>Our audit procedures included testing the design and implementation of key controls around the impairment review processes and assessing the appropriateness of the methodology applied by the Directors in calculating the impairment charges, and the judgements applied in determining the cash generating units ("CGUs") of the business, which the Group has determined as being individual stores and, in the UK, the general merchandising online business.</p> <p>In relation to the completeness of the Group's impairment review process, we have assessed the completeness of the Group's impairment charges and impairment reversals with reference to CGU performance.</p> <p>In relation to the Group's 'value in use' valuations, we have assessed the review completed by the Group by:</p> <ul style="list-style-type: none"> <li>• assessing the methodology applied in determining the value in use compared with the requirements of IAS 36 Impairment of Assets and checking the integrity of the impairment model utilised by the Group;</li> <li>• challenging the key assumptions utilised in the cash flow forecasts with reference to historical trading performance, market expectations and our understanding of the Group's strategic initiatives;</li> <li>• assessing the long-term growth rates and discount rates applied to the impairment review for each country, comparing the rates utilised to third party evidence and in relation to the discount rate, our independently estimated discount rates; and</li> <li>• completing sensitivity analysis in relation to key assumptions to consider the extent of change in those assumptions that either individually or collectively would be required for the assets to be impaired, in particular relating to forecast future cash flows, including any sub-lease income received, long-term growth rates and discount rates applied.</li> </ul> <p>In relation to the Group's 'fair value less costs of disposal', we have challenged the assumptions used by the Group in determining the fair market value of the assets, including those completed by external valuers, using internal property valuation specialists and assessing whether appropriate valuation methodologies have been applied.</p>	<p>We note that cash flow forecasting, impairment modelling and property values are all inherently judgemental. Nevertheless, whilst we note further actions are required by the Group to achieve these forecasts over the medium term, we concluded that the assumptions applied in the impairment models were within an acceptable range, and that the overall level of net impairment recognised was reasonable.</p> <p>We also agree that the disclosure of the net impairment as an exceptional item is in accordance with the Group's policy on exceptional items and is reasonable.</p>



Risk description	How the scope of our audit responded to the risk	Key observations
<b>Recognition of commercial income</b>		
<p>As described in Note 1 (accounting policies, including disclosure within 'use of assumptions and estimates' disclosure) to the financial statements, the Group has agreements with suppliers whereby volume-related allowances, promotional and marketing allowances and various other fees and discounts are received in connection with the purchase of goods for resale from those suppliers. As such, the Group recognises a reduction in cost of sales as a result of amounts receivable from suppliers for goods sold.</p> <p>In accordance with IFRS, commercial income should only be recognised as a deduction from cost of sales within the income statement when the performance conditions associated with it have been met. As such, judgement exists in determining the period over which the reduction in cost of sales should be recognised, requiring both a detailed understanding of the contractual arrangements in addition to complete and accurate source data on purchase volumes and fulfilment of promotional programmes.</p> <p>In light of the accounting errors identified in the prior year in this area, the Group completed a detailed internal review of the factors which gave rise to these errors and the controls associated with the recognition of commercial income amounts.</p>	<p>In completing our work, we obtained a detailed understanding of the work completed by Tesco, together with obtaining an understanding and evaluating the design and implementation of controls that the Group has established in relation to commercial income. This included testing the completeness and accuracy of the systematic inputs upon which the Group's controls rely, such as sales volume data.</p> <p>In addition, our substantive audit procedures across the Group's retail operations included a combination of the following:</p> <ul style="list-style-type: none"> <li>• we tested that amounts recognised were accurate and recorded in the correct period based on the contractual performance obligations by agreeing a sample of individual supplier agreements. We circularised a sample of suppliers to test whether the arrangements recorded were complete and interviewed a sample of buyers to supplement our understanding of the contractual arrangements. Where responses were not received, we completed alternative procedures such as agreement to underlying contractual arrangements;</li> <li>• we used data analytics to profile commercial income, identifying key risk deals upon which we completed detailed testing; and</li> <li>• we reviewed Groceries Supply Code of Practice ("GSCOP") reporting and correspondence to the supplier hotline in order to help identify any areas where further investigation was required.</li> </ul>	<p>The results of our testing were satisfactory.</p> <p>We consider the disclosure given around supplier rebates to provide an appropriate understanding of the types of rebate income received and the impact on the Group's balance sheet as at 27 February 2016.</p>

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## Independent auditor's report to the members of Tesco PLC continued

Risk description	How the scope of our audit responded to the risk	Key observations
<b>Inventory valuation and provisions</b>		
<p>As described in Note 1 (accounting policies) and Note 15 (inventories), the Group carries inventory at the lower of cost and net realisable value. As at 27 February 2016, the Group held inventories of £2,430m (2014/15: £2,957m).</p> <p>The Group applies particular judgement in the following areas relating to inventory:</p> <ul style="list-style-type: none"> <li>following changes in the Group's inventory provisioning methodology in the prior year, the Group provides for obsolescence based on forecast inventory usage. This methodology relies upon assumptions made in determining appropriate provisioning percentages categories of inventory; and</li> <li>the Group capitalises certain directly attributable overheads within the cost of inventory. These overheads relate to the costs incurred in bringing inventory to its final destination for sale and in line with normal market practice includes the costs associated with the Group's distribution centres.</li> </ul> <p>In addition, given the overall level of inventory across the business in multiple locations, we identified the existence of inventory to be a further area of focus for our audit work.</p>	<p>We tested the operating effectiveness of controls associated with the existence and condition of inventory by attending a sample of inventory counts throughout the year in all significant locations (including stores and distribution centres). Across the Group, we attended 222 inventory counts within stores and 28 inventory counts within distribution centres.</p> <p>We obtained assurance over the appropriateness of management's assumptions applied in calculating the value of inventory provisions by:</p> <ul style="list-style-type: none"> <li>critically assessing the Group's inventory provisioning policy, with specific consideration given to aged inventory (especially for non-food and general merchandising products) as well as stock turn calculations including the impact of seasonality;</li> <li>verifying the value of a sample of inventory to confirm it is held at the lower of cost and net realisable value, through comparison to vendor invoices and sales prices;</li> <li>using data analytics in relation to the UK business to recalculate the provision based on the Group's provisioning policy; and</li> <li>reviewing historical accuracy of inventory provisioning with reference to inventory write-offs during the year in relation to stock loss or other inventory adjustments.</li> </ul> <p>In relation to the capitalisation of directly attributable costs, we assessed the nature of costs capitalised and for a sample of individual products, assessing whether costs had been correctly allocated.</p>	<p>The results of our audit work were satisfactory and we concur with the nature of costs capitalised within the inventory balance and the level of provision held.</p> <p>In relation to the inventory provisioning policy, we concur that the total level of provision is within an acceptable range.</p>
<b>Pension obligation valuation and accounting for the pension curtailment</b>		
<p>As described in Note 1 (accounting policies) and Note 26 (post-employment benefits), the Group has a defined benefit pension plan in the UK. At 27 February 2016, the Group recorded a net retirement obligation of £3,175m (2014/15: £4,842m), comprising scheme assets of £10,302m (2014/15: £9,677m) and scheme liabilities of £13,477m (2014/15: £14,519m).</p> <p>During the period, the Group closed the UK scheme to new entrants and future accrual and replaced it with a new defined contribution scheme. As such, a curtailment gain of £538m (2014/15: £nil) has been recognised and treated as an exceptional item, offset by one-off payments of £58m relating to auto-enrolment and top-up payments to the new contribution defined contribution scheme.</p> <p>The pension valuation and associated curtailment gain is dependent on market conditions and key assumptions made, in particular relating to investment markets, discount rate, inflation expectations and life expectancy assumptions. The setting of these assumptions is complex and requires the exercise of significant management judgement with the support of third party actuaries.</p>	<p>In relation to the pension curtailment gain, we have assessed the basis of the gain recognised and tested the integrity of the calculation.</p> <p>In testing the pension valuation and curtailment gain, we have utilised internal pension actuarial specialists to review the key actuarial assumptions used, both financial and demographic, and considered the methodology utilised to derive these assumptions. Furthermore, we have benchmarked and performed a sensitivity analysis on the key assumptions determined by the Directors.</p> <p>We tested the membership data utilised in the valuation of the schemes to assess whether the basis of the valuation is appropriate.</p> <p>Furthermore, we have assessed the disclosure of the curtailment gain as an exceptional item.</p>	<p>From the work completed, we are satisfied that the methodology and assumptions applied in relation to determining the pension valuation and curtailment gain are appropriate.</p> <p>We also agree that the disclosure of the curtailment gain as an exceptional item is in accordance with the Group's policy on exceptional items and is reasonable.</p>

Risk description	How the scope of our audit responded to the risk	Key observations
<b>Provisions and reserves in Tesco Bank</b>		
<p>As described in Note 1 (accounting policies) and Note 22 (financial risk factors) and Note 24 (provisions), the Group is required to make a number of complex judgements relating to provisions and reserves held by Tesco Bank, specifically in relation to:</p> <ul style="list-style-type: none"> <li>loan impairment provisioning, where judgements include estimating the level of impaired loans and the expected cash recoveries thereon;</li> <li>conduct risk provisioning, where judgements are required in relation to assessing the level of provision required in relation to historical payment protection insurance and the Consumer Credit Act redress programme; and</li> <li>insurance reserving in light of the Group's exposure to insurance claims through its investment in Tesco Underwriting Limited.</li> </ul>	<p>We have tested the design and implementation of key controls relating to loan impairment provisioning, conduct risk provisioning and insurance reserving. In addition, we have challenged the judgements taken by management, specifically:</p> <ul style="list-style-type: none"> <li>in relation to loan impairment provisioning, using internal specialists, we tested a sample of the data used in the models as well as testing the model methodology and calculations. We assessed whether the modelling assumptions used considered all relevant risks, and whether the additional adjustments to reflect un-modelled risks were reasonable in light of historical experience, economic climate, current operational processes and the circumstances of the customers as well as our own knowledge of other practices; and</li> <li>in relation to conduct risk provisioning, we challenged the adequacy of provisions recognised by critically assessing the key assumptions used in the provision models, comparing the assumptions to available peer and historical data. This work also included, amongst other things, reviewing regulatory correspondence and the bank's complaint logs as well as comparing the bank's position with our own knowledge and experience; and</li> <li>in relation to insurance reserving, using internal insurance specialists, we have understood the key judgements and assumptions used to estimate the level of claims reserves.</li> </ul>	<p>As a result of our work, we concluded that the provisions and reserves held by Tesco Bank in relation to loan impairment provisions, conduct risk provisions and insurance reserving were reasonable.</p>
<b>Compliance with laws and regulations</b>		
<p>In light of the ongoing investigation by the Serious Fraud Office ("SFO") in the UK following the commercial income misstatements identified in the prior year (see page 46 of the Audit Committee report and Note 31 (commitments and contingencies) of the Group financial statements), the Group has a number of potential litigation and other exposures for which the outcome is uncertain.</p> <p>As a result, judgement is required in assessing the nature of these exposures and their accounting and disclosure requirements.</p>	<p>In assessing the potential exposures to the Group, we have completed a range of procedures including:</p> <ul style="list-style-type: none"> <li>assessing the design and implementation of controls in relation to the monitoring of known legal exposures;</li> <li>reading Board and other meeting minutes to identify areas subject to Group consideration;</li> <li>meeting with the Group's internal legal advisors in understanding ongoing and potential legal matters impacting the Group;</li> <li>reviewing third party correspondence with external legal advisors, regulators and GSCOP; and</li> <li>reviewing the proposed accounting and disclosure of actual and potential legal liabilities, drawing on third party assessment of open matters.</li> </ul>	<p>From the work completed, we concur with management's position that no provision is required and that the disclosures provided are appropriate.</p>

Strategic report

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Other information

## Independent auditor's report to the members of Tesco PLC continued

Risk description	How the scope of our audit responded to the risk	Key observations
<b>Management override of controls</b>		
<p>There are a number of areas within the Group's financial statements which comprise accounting estimates by management and accordingly there is a risk that the Group's results are influenced through management bias in determining such estimates.</p> <p>Specifically this risk lies in those areas with high levels of judgement such as commercial income, value-in-use calculations within the impairment reviews, inventory accounting and provisioning.</p> <p>Furthermore, the presentation of non-GAAP measures is judgemental, with IFRS only requiring separate presentation of material items. Management judgement is therefore required in determining the classification of exceptional items.</p>	<p>In order to address this risk, in addition to the procedures set out in the commercial income, impairment and inventory risks set out above, we have completed audit procedures including:</p> <ul style="list-style-type: none"> <li>• assessing the design and implementation of controls which address the risk of management override, such as the overall 'entity level' controls which underpin the overall control environment for the Group;</li> <li>• auditing key areas of management estimate and judgement, including consideration of exceptional items disclosed by the Group and the existence of any further potential exceptional items included within the Group's underlying profit measures;</li> <li>• using data analytics, tested journal entries for fraud characteristics by testing the completeness of the journal population reviewed and risk profiling the population to focus our work on journals of interest;</li> <li>• assessing transactions completed outside of the normal course of business; and</li> <li>• obtaining an understanding of the work of internal audit so as to assist us in directing our audit effort and obtain greater understanding of the controls in place across the Group.</li> </ul>	<p>From our work completed, we have no matters to highlight in these areas.</p> <p>However, we note that consistent with other businesses of a similar scale to the Group, there are offsetting non-recurring income and expense items included within underlying profit which do not meet the Group's definition of exceptional items. We concur that these have been appropriately included within underlying profit as they do not distort the overall result reported.</p>
<b>Retail technology environment, including IT security</b>		
<p>The Group's retail operations utilise a range of information systems where we identified deficiencies in certain controls at the IT infrastructure level. These could have an adverse impact on the Group's controls and financial reporting systems.</p>	<p>We tested the design and operating effectiveness of the Group's controls over the information systems that are important to financial reporting and identified weaknesses in the control environment.</p> <p>Where these deficiencies affected applications and databases within the scope of our audit, we completed a combination of controls and substantive testing in order to determine whether we could place reliance on the completeness and accuracy of system generated information, including:</p> <ul style="list-style-type: none"> <li>• determined whether authorised inappropriate changes had been made to the affected databases and IT application systems; and</li> <li>• assessed the design and operating effectiveness of any controls that mitigated the identified risks.</li> </ul> <p>In addition, and where appropriate, we extended the scope of our substantive audit procedures.</p>	<p>We identified weaknesses in relation to user access and change management controls in relation to the Group's retail financial reporting systems and which the company is addressing as detailed within the Audit Committee Report on page 47.</p> <p>Where these deficiencies affected applications and systems within the scope of our audit, we completed additional substantive testing in order to assess the completeness and accuracy of system generated information.</p>

Last year the previous auditor's report included two other risks which are not included in our report this year: commercial income – impact on prior periods (there have been no such adjustment recognised in the current period) and impairment of investments in associated undertakings (following the impairment recognised in the prior period, we do not believe that this risk requires separate identification).

There are two new risks which have been detailed above in the current year: pension obligation valuation and accounting for the pension curtailment (following the closure of the Group's UK defined benefit scheme to future accrual during the year) and IT environment, including IT security (in light of the identified weaknesses in relation to user access and change management controls).

#### **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 £50m (2014/15: materiality determined by the previous auditor of £50m). Professional judgement was applied in determining an appropriate level of materiality and we considered a number of profit based and other measures with reference to the Group's performance. We have concluded that it was appropriate to determine materiality with reference to the Group's average profitability over a three year period (2013/14, 2014/15 and 2015/16), adjusted for exceptional items.

In our professional judgement, we believe that the use of an adjusted profit measure is appropriate as the amounts which have been excluded from the Group's profit before tax are one-off items which would otherwise skew the level of materiality determined and are not reflective of the Group's trading activity. However, we capped the materiality determined to that applied by the previous auditor in the prior year in light of the Group's lower level of profit in the current year and as a result of 2015/16 being our first year of appointment.

We agreed with the Audit Committee that we would report to the Committee all audit differences in excess of £2.5m (2014/15: £2.5m determined by the previous auditor), 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. Following the disposal of the Group's business in Korea, the Group has wholly-owned grocery retail operations in nine countries, together with interests in a number of other businesses both in the United Kingdom and internationally.

The Group's accounting process is structured around local finance functions and is further supported by a shared service centre in Bengaluru, India which provides accounting and administrative

support for the Group's core retail operations. Each local finance function reports into the central Group finance function based at the Group's head office. Based on our assessment of the Group, we focused our group audit scope primarily on the audit work on nine retail locations (United Kingdom, Ireland, Czech Republic, Hungary, Poland, Slovakia, Turkey, Malaysia and Thailand), Tesco Bank and dunnhumby. All of these were subject to a full audit and represent 97% of the Group's revenue.

In addition, four other businesses in the United Kingdom were subject to specific audit procedures on material account balances, where the extent of our testing was based on our assessment of the risks of material misstatement and of the materiality of the Group's operations at those locations.

At the parent entity level we also tested the consolidation process and carried out analytical procedures to confirm our conclusion that there were no significant risks of material misstatement of the aggregated financial information of the remaining components not subject to audit or audit of specified account balances.

The most significant component of the Group is its retail business in the United Kingdom. As such, there is extensive overlap between the Group and United Kingdom audit team to ensure an appropriate level of involvement in this audit work. During the course of our audit, we visited 75 retail stores in the United Kingdom to attend either inventory counts or in order to complete store control visits, and seven distribution centre inventory counts.

Since this was our first year as the Group's auditor, we visited 10 of the 11 significant locations set out above at least twice and the least significant of those locations once, in addition to the Group's shared service centre in Bengaluru, with the Group Audit Partner visiting four of these locations. We also had a dedicated audit partner focussed on overseeing the role of the component audit teams located outside of the UK and Ireland, ensuring that we applied a consistent audit approach to the operations in the Group's International business. The audit visits by the Group audit team were timed to enable us to be involved during the transition, planning and risk assessment process in addition to during the completion of detailed audit procedures. During our visits, we attended key meetings with component management and auditors, and reviewed detailed component auditor work papers.

In addition, all key component audit teams were represented during a centralised two-day planning meeting held in the United Kingdom following our appointment and prior to the commencement of our detailed audit work. The purpose of this planning meeting was to ensure a good level of understanding of the Group's businesses, its core strategy and a discussion of the significant risks and workshops on our planned audit approach. Group management also attended to support these planning activities.

Going forward, we will continue to visit all key components at least on an annual basis.

## Independent auditor's report to the members of Tesco PLC continued

### 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 part of the Corporate Governance Statement relating to the company's compliance with certain 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). 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 independent partner reviews.

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.

#### Panos Kakoullis (Senior Statutory Auditor)

for and on behalf of Deloitte LLP  
Chartered Accountants and Statutory Auditor  
London, United Kingdom  
12 April 2016

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