Out with the old, in with the new

Observations from EY’s review of December 2013 annual reports in the FTSE 350, with recommendations for 2014

September 2014
Revised International Standards on Auditing (UK and Ireland) 700 requires the auditor to give insight on key aspects of their audit, including: an overview of the scope of their audit, the materiality used and the key audit risks and how these were addressed. The changes go hand in hand with enhanced audit committee disclosures on the significant issues considered by the committee in relation to the financial statements (discussed in Section 5).

In terms of the scope of the audit, we found that on average auditors obtain 90% coverage of the group. This is measured against key metrics, most commonly, revenue, profit before tax or total assets.

From our conversations with investors, materiality, in terms of its calculation and application remains of key interest. This is encouraging, as it is the exact reason why these disclosures were provided — to create a dialogue between companies, investors and auditors. However, risk is also a key determinant of how much audit work is done. The most commonly used metric to calculate materiality is profit before tax.

The auditors’ reports we reviewed report an average of four audit risks. It should not come as a surprise that not all significant issues disclosed by the audit committee mirror what the auditor discloses as areas of risk. The main driver for this difference is that many audit reports contain risks of management override and revenue recognition — which are ‘presumed’ risks under auditing standards.

Management override is included as an audit risk in 35% of audit reports. We would not necessarily expect the audit committee report to include this as a risk, although a very small minority did. The spirit behind this disclosure is to provide more transparency on the work of the committee and therefore it is important that the disclosures reflect this spirit rather than replicate what the auditor reports.

Revenue recognition is stated as an area of audit emphasis in 57% of the audit reports in our sample.

We note that one or two audit reports were issued with explicit ‘findings’ in relation to the auditors’ work on the key risks. This has not yet become a more widespread practice but it is an area which we expect to develop. We will be continuing to consider how best to meet investor expectations whilst recognising that an audit opinion is given on the accounts as a whole not individual elements of it.

Recommendations for the auditor’s report

► Investors might question companies about the contents of the audit report, so boards should understand its contents. Examples of questions could include:

► What debate did the audit committee have with the auditor over its scope and materiality?

► What was the extent of procedures performed on significant issues?

► Why are there some risks areas mentioned by the auditor that do not feature in the audit committee’s report?

► EY’s publication Shareholder engagement and corporate reporting at a cross roads contains a more comprehensive list of questions that investors may ask on the contents of the audit report. We encourage you to read it.
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