Audit Reports – a Buried Treasure

Within a very short time frame auditors' reports for UK listed entities have changed dramatically. Up to a couple of years ago, the reports consisted largely of standard language and a pass/fail opinion. Users would pause only to see if there were modifications in the audit report and then move on. Reports were virtually the same for all companies, whatever the entity structure or industry.

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Times have changed, and with the revisions to ISA (UK&I) 700 in 2013 that require the auditor to describe the key planning decisions of the audit, their perspective on the risks facing the company and how the audit responded to those risks, suddenly there is something worth reading. In fact, today's reports are packed full of useful information and can often act as a guide to what's particularly important in the financial statements. Moreover, they are now interesting, a hot topic and the subject of discussion like never before! This is not only a UK phenomenon - it's also global, with the EU and international auditing standard-setters introducing enhanced audit report requirements from only next year.

So what is all the fuss, and why should the investor be interested in extended audit reports?

The extended report, as a stand-alone document, provides the auditor's unique perspective on the risks facing the company. In doing so, it should direct the reader to the key areas of judgement in the financial statements. It provides straightforward insight into complex accounting treatments and the impact of material transactions. If done well, it can also be an integral part of the Annual Report as a whole, complementing and linking up with the Audit Committee Report and the principal risk disclosures. The extended audit report also gives insight into the work the auditor has performed, which previously has been something of a mystery.

How to make the most of the extended audit report

Gilly Lord

Areas of focus

The areas of focus (also known as "risks and responses") is probably the most useful section of the extended audit report for the reader. It identifies the areas of the financial statements on which the auditor focused most of their effort and explains the work performed by the auditor in response to these. A good audit report will explain *why* this took so much effort, quantifying the balances involved and highlighting important judgements. It will break down the area into elements based on the associated risk and will describe how the audit addressed each of those elements. A good audit report will highlight events and conditions that have impacted the financial statements and the associated risks, and will direct the reader to that part of the financial statements where they can find out more. It can also provide "micro-views" that the reader can use to understand how easy or difficult the auditor's judgements were and so provide the reader with the basis for a more in-depth discussion with the directors.

Materiality

In layman's terms, materiality is the level at which a misstatement could influence the economic decisions of the users of the financial statements. In an audit, materiality is used to determine where the auditor should focus the audit work and the nature of the work to be performed. It is also used as a benchmark for evaluating any misstatements identified. It is, however, a concept, not an exact science and, as such, is open to professional judgement. Because of this it has been a very difficult area for the outsider to understand.

To combat this, the extended audit report includes an explanation of the materiality the auditor has applied. This helps the reader to better understand one of the most important inputs into the audit process and the thought process behind its determination, which helps to put context around the audit. Ultimately, the explanation of materiality should reduce the expectation gap about what an audit does, and does not involve.


Jayne Kerr

A common materiality benchmark is 5% of profit before tax, which is a generally accepted "norm" for profit-orientated entities. However, often auditors adjust this benchmark to remove the impact of distorting factors, such as non-recurring exceptional items. A good audit report will explain *why* a particular benchmark has been selected and the rationale for any adjustments made.

Scoping

The extended audit report also includes a section on the scope of the audit. This explains how the audit was designed in order to gather sufficient evidence on the financial statements, focusing in particular on the most significant risks of material misstatement. This section is useful as it focuses on how audit evidence was obtained through the work of both group and other auditors and the extent to which audit work has "covered" the account balances. For instance, an auditor could decide that if 90% of revenue has been subject to detailed audit procedures, less detailed work is needed on the remaining 10%. It also provides insight into where the senior members of the audit team spent their time; and in so doing highlighting what might be the more risky and/or complex areas.

The shareholder voice

The extended audit report, if well prepared, is a big step forward in increasing the transparency and trustworthiness of the financial statements. As auditors, we are working hard to make the reports as meaningful and useful as we can so that it can be used by you as a tool to help you navigate the Annual Report, break down the vast amount of information presented and give you a hook for your discussions with the directors.

The audit report is prepared for you, the shareholders. We encourage you to make the most of it by actively engaging with the Audit Committee Chair if there is something you don't understand, agree with or feel is insufficiently covered.

Think of it as buried treasure just waiting to be uncovered!