

In a Rapidly-Changing World, Audit Does have a Future, Stresses IAASB Chairman



A noted proponent of global best practices in Auditing and Assurance, Prof Arnold Schilder has been the Chairman of International Auditing and Assurance Standards Board (IAASB) since 2009. His term has been recently extended in view of his key contribution in guiding the IAASB for enhancing the quality and consistency of world auditing and assurance practices, and the current review of potential enhancements to international standard-setting arrangements. He is globally acclaimed for having successfully used the wealth of his experiences in the initiatives undertaken by the IAASB. In this special write-up penned for The Chartered Accountant journal, he convincingly stresses that in a Rapidly-Changing World, Audit Does have a Future. He says that as long as auditors stick to honesty, and perform their work efficiently, audit will have its future. But... 'challenges' are all over the place. To moot his point he quotes the then Vice-President of India Dr. Sarvepalli Radhakrishnan, who later became our second President: "Whatever you do you must have that standard that you are doing something ennobling...you have a vital contribution to make to the progress of the country and you can make that contribution through honesty and efficiency." Read on...



Prof. Arnold Schilder

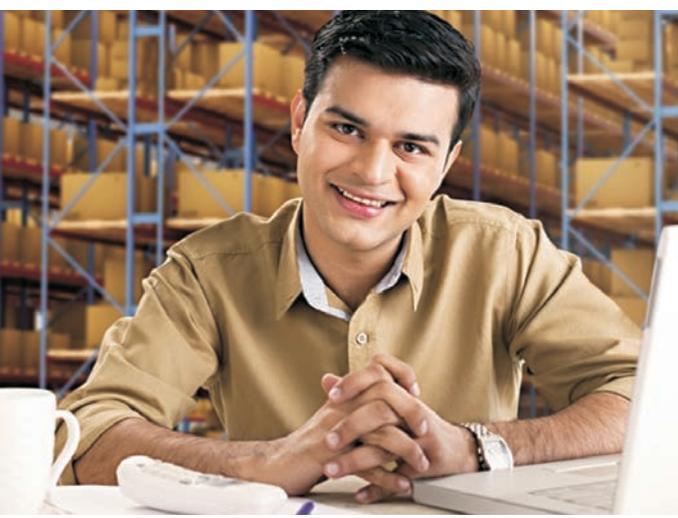
(The author is Chairman of International Auditing and Assurance Standards Board (IAASB). He can be reached at a.schilder@nba.nl or tonymirenda@ifac.org.)

The Institute of Chartered Accountants of India, ICAI, is celebrating its 68th birthday. Our warm congratulations! ICAI President CA. Nilesh Shivji Vikamsey suggested the title for this article that I wholeheartedly subscribe to.

When reading his President's Message- May 2017¹, I was impressed by a quote from the early days

¹ http://www.icai.org/new_post.html?post_id=7027

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of ICAI. “In 1957, the then Vice-President of India Dr. Sarvepalli Radhakrishnan, who later became India's second President, had said addressing the Chartered Accountants: *“Whatever you do you must have that standard that you are doing something ennobling... you have a vital contribution to make to the progress of the country and you can make that contribution through honesty and efficiency.”*

Honesty and efficiency: as simple as that. Ethics and professionalism. The ethics pillar first, well known from related principles as objectivity, integrity, independence. And in one breathe the other pillar, professionalism: education, knowledge, skills, expertise, judgment and reporting. The two pillars together form that one standard, so well described as *“...doing something ennobling...a vital contribution to the progress of the country”*. We often call that *‘the public interest’*.

Simply said – as long as auditors stick to honesty, and perform their work efficiently, audit will have its future. But... ‘challenges’ are all over the place. By definition audits are carried out amidst conflicting interests between principals and agents. But also, as the title suggests, the world is rapidly changing. All of that is not new, but very true.

So let me address below some topics that are centre in the changes that auditors have to deal with.

The New Auditor's Report

Early 2015 the IAASB published its new and revised standards on auditor reporting.² The changes have already become mandatory in many parts of the world. In particular, the reporting of so called Key Audit Matters (KAM) is a major innovation in the public independent auditor's report.

Why did the IAASB change the auditor's report so drastically? From independent research and intense outreach we had learned that the audit opinion is valued, but could be more informative: users want more relevant and decision-useful information about the entity and the financial statement audit. The IAASB believes that the changes to the auditor's report have a number of expected benefits: enhanced communicative value to users; more robust interactions among users, auditors and those charged with governance (TCWG); increased attention by management and TCWG to the disclosures referred to in the KAM section of the auditor's report; increased professional skepticism in

areas where KAM are identified; and increased audit quality or users' perception of audit quality. KAM are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. A KAM section is required in the auditor's report for audits of financial statements of listed entities in accordance with new International Standard on Auditing (ISA) 701;³ but it may also be required by law or regulation for other entities, or the auditor may provide KAM voluntarily.

Since KAM first started to appear in public auditor's reports in the United Kingdom, I have been impressed by how much more relevant the auditor's report has become. There are on an average five pages describing the KAMs that help users to understand matters most significant in a specific audit. In the UK, investors have even issued special Awards for the most insightful and most informative auditor's reports. No one would have believed in such positive auditor publicity a few years before. On the contrary, when we had our consultations from 2011-2014, there was a lot of skepticism and doubt. We learned from these consultations, and improved the drafts. But this period also allowed for our many stakeholders to becoming familiar with the concepts and prepare for this major change in behaviour, as well as understanding the roles of each participant: management, audit committees, regulators, and multiple users. This illustrates that standard-setting needs time for robust global dialogue, and cannot be done overnight!

I understand that auditors in India have asked for more time to fully prepare for these new style reports. Therefore, the Council of ICAI has deferred the implementation date by one year to 2018. I read in the Council's Announcement⁴: *“There is need to provide adequate training and implementation guidance to the members on these standards so as to equip them with the requirement and to implement these standards appropriately. It was then noted that issue of Implementation Guide and training programmes may take considerable time.”* I understand that. The IAASB has deliberately left much of what KAM to report and how to report it to the professional judgment of the auditor. It is essential for KAM to be entity-specific and avoid

² <http://www.iaasb.org/new-auditors-report>

³ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

⁴ <http://resource.cdn.icai.org/45050aasb010417.pdf>

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standardised or overly technical language. KAM are determined by the auditor's consideration of: the nature and extent of communication with TCWG; the importance to intended users' understanding of the financial statements; the nature and extent of audit effort needed to address the matter; the nature of the underlying accounting policy, its complexity or subjectivity; the nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error (if any); the severity of any control deficiencies identified relevant to the matter (if any); and /or the nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant/reliable audit evidence.

Given the importance of this innovation, and the understandable need for education and clarification, the IAASB has established a special Auditor Reporting Implementation Working Group. The Auditor Reporting website page (see footnote 2) contains a number of helpful resources including a toolkit and Questions and Answers for potential implementation issues. The Working Group, in particular its co-chairs, have been available for presentations and clarification about implementation.

This 'major overhaul,' 'revolution' or 'step change' (as others have coined it) is essential to the relevance and perceived quality of audits worldwide. It calls for the 'honesty and efficiency,' ethics and professionalism in the public interest that we heard about earlier. It is that 'vital contribution' that Dr. Radhakrishnan called for.

Modernisation of Financial Estimate Audits in Support of Audit Quality

In April 2017, the IAASB published an Exposure Draft of ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures ('ED-540')⁵. It is a good illustration of how audit has responded

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In April 2017, the IAASB published an Exposure Draft of ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures ('ED-540'). It is a good illustration of how audit has responded to rapid changes to remain future-proof. A major driving force for this revision is the impending adoption of International Financial Reporting Standard (IFRS) 9, Financial Instruments—which is effective in 2018.

to rapid changes to remain future-proof. A major driving force for this revision is the impending adoption of International Financial Reporting Standard (IFRS) 9, *Financial Instruments*— which is effective in 2018. "In proposing revisions to ISA 540, the IAASB recognised that serving the public interest included modernising ISA 540 for evolving financial reporting frameworks. Accounting estimates in accordance with IFRS 9 and other recent financial reporting standards will often give rise to greater estimation uncertainty, require greater use of modelling and forward-looking information, and involve the need for an enhanced control or governance environment. These financial reporting standards often require enhanced disclosures that explain the basis on which accounting estimates have been made and the significant judgements and assumptions involved." (quoted from the Explanatory Memorandum to ED-540).

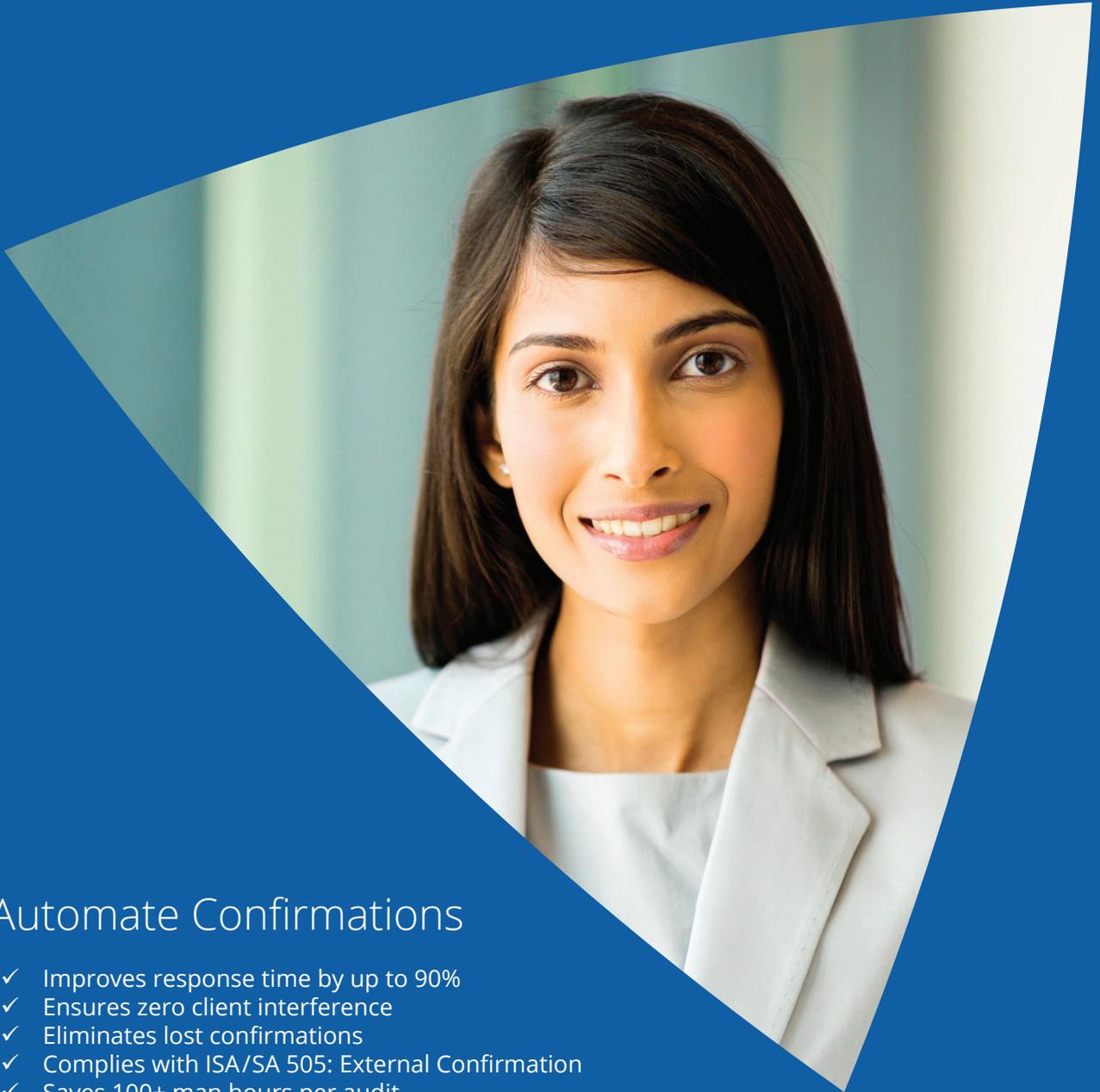
The IAASB's Task Force for this large project included IAASB Member CA. Abhijit Bandyopadhyay, with the support of his Technical Advisor CA. Sanjay Vasudeva. It is a good illustration of the direct support of ICAI to the IAASB, and much appreciated. I may also note that the Chairman of the Auditing and Assurance Standards Board of India CA. Shyam Lal Agarwal has observed several IAASB meetings.

ED-540 deals with many auditing challenges. The quote above refers to significant judgements and assumptions, estimation uncertainty, (complex) modelling, forward-looking information, enhanced controls and disclosures. One can easily understand that the audit of estimates may often qualify for inclusion in the KAM. The accounting of estimates will often require robust audit work. Here we also see the relevance of ethics and professionalism. This comes together in a key concept that has been emphasised in ED-540: the use of professional skepticism.

⁵ <http://www.ifac.org/news-events/2017-04/iaasb-proposes-modernization-financial-estimate-audits-support-audit-quality>



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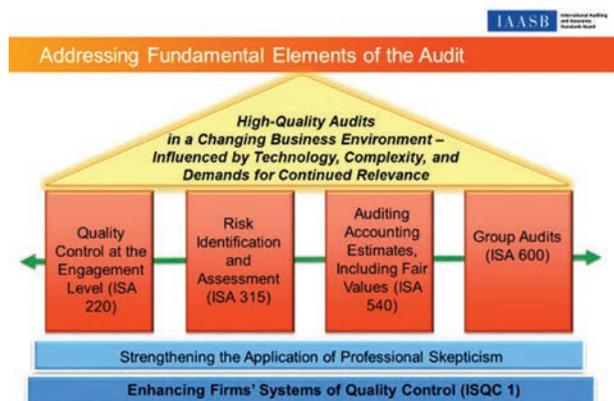
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The IAASB has taken a number of steps to enhance the application of professional skepticism throughout this standard. These include: developing an independent view of expected estimates and disclosures; building awareness of potential indicators of management bias throughout the process; a more rigorous risk assessment, driven by consideration of specific risk factors; a determination of procedures to respond to those risks; and a stand-back requirement to force a “second look”.

Another interesting feature of ED-540 is the explicit inclusion of scalability in the requirements. When inherent risk is assessed as low, clear overall procedures may be enough, such as obtaining evidence about events occurring up to the date of the auditor’s report; testing how management made the accounting estimate and the data on which it is based; or developing a point estimate or range. However, when inherent risk is not assessed as low, the auditor needs to design further procedures to address complexity, judgment and estimation uncertainty. This scalability may help auditors of small companies to achieve a cost-effective audit. In a country like India with its many small practitioners and mandatory audits for small companies, this is highly relevant.

The IAASB is looking forward to the comments from stakeholders. I encourage ICAI to respond as well. We hope that the feedback will confirm that this is a good contribution to ‘the future of audit in a rapidly-changing world’!

The ‘House of Audit’- Renovated for the Future



Auditor Reporting and Accounting Estimates are two key priorities for the IAASB. But there is much more on our agenda to support high quality audits in a changing business environment. Auditor Reporting and Accounting Estimates are two key priorities for the IAASB. But there is much more on our agenda to support high quality audits in a changing business environment.

Auditor Reporting and Accounting Estimates are two key priorities for the IAASB. But there is much more on our agenda to support high quality audits in a changing business environment. This is summarised visually in the ‘House of Audit’- Renovated for the Future.

Quality Control by firms⁶ and at the engagement level⁷ are two key, related work streams. A robust system of quality control is important in every business, and certainly in auditing. The IAASB is discussing a new quality management approach in the revisions to ISQC 1, to accommodate improvements to the robustness of ISQC 1, while at the same time providing the necessary flexibility to facilitate the application of this standard by firms of all sizes and who perform a variety of engagements. The revised ISQC 1 likely will include as key components:

Governance and leadership, organisation, culture and a strategy that foster quality; Information and communication; and The quality management process — this is the new component to be introduced to ISQC 1 and includes establishing the firm’s quality objectives, performing an assessment of the risks to quality, designing and implementing responses to quality risks, and monitoring and remediation.

Incorporating quality management principles in ISQC 1 will improve the robustness of the firms’ system of quality management, because firms would be required to consider their circumstances and environment, and be responsive to their quality risks. This will result in firms focusing their efforts on addressing those risks, rather than a “checklist-based” approach of implementing quality controls that could be redundant to the firm. That

⁶ International Standard on Quality Control (ISQC) 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements and Related Services Engagements

⁷ ISA 220, Quality Control for an Audit of Financial Statements



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is, it should be a proactive 'first time right' approach rather than a compliance exercise after the fact.

Like in ED-540, scalability is an important part of our considerations. The requirements regarding the Quality Management Process would require the firm to identify quality objectives that are relevant to the firm, and to assess the risks of not meeting those objectives (quality risks). The responses to quality risks need to be commensurate. Furthermore, the requirements addressing the firm's monitoring and remediation activities would emphasise that the nature and extent of these activities would depend on factors such as the size of the firm, the services the firm provides, and the nature of the entities to whom those services are provided.

At the same time, quality management principles are also being built into ISA 220 for audits, building on the principles in ISQC 1.

The 'House of Audit' shows other key projects as well, in particular regarding risk assessment (ISA 315⁸) and group audits (ISA 600⁹). Sharing more about these projects would make this article too long. But a number of elements that were described above will come back in the revisions of these ISAs, including professional skepticism, quality management and scalability.

I will conclude with a brief discussion of **Technology, and Data Analytics**.

Technological change is moving at a rapid pace, ushering in the capability to capture and communicate data digitally, on an unprecedented scale and almost instantaneously. This has resulted in an increasing focus on data, whether structured or unstructured, and whether generated internally or externally. The use of data analytics in the audit of financial statements is at an early stage. Auditors are expanding the areas of use and audit regulators and oversight bodies are just beginning to see the impact of the use of data analytics in the audit through inspection activity.

The ISAs do not prohibit nor stimulate the use of data analytics. But the ISAs need to better address increasing complexity, taking into account rapidly changing technological developments. Therefore, in 2016 we published a Request for Input: *Exploring*

The ISAs do not prohibit nor stimulate the use of data analytics. But the ISAs need to better address increasing complexity, taking into account rapidly changing technological developments. Therefore, in 2016 we published a Request for Input: *Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics*. This publication informed stakeholders about the IAASB's ongoing work to explore effective and appropriate use of technology, with a focus on data analytics, in the audit of the financial statements.



*the Growing Use of Technology in the Audit, with a Focus on Data Analytics*¹⁰. This publication informed stakeholders about the IAASB's ongoing work to explore effective and appropriate use of technology, with a focus on data analytics, in the audit of the financial statements. We are very pleased with the high level feedback of responses, and will discuss that feedback at our June 2017 meeting. We believe that the ISAs must continue to form the basis for high-quality, valuable and relevant audits and cannot inhibit innovation or stifle potential best practices of the future. On our website there is an interesting video on this topic.¹¹ ICAI's *Digital Transformation and Process Reengineering Group* and others may enjoy it.

ICAI's Vision 2030¹² emphasises its role as 'A regulator and developer of Trusted and Independent professionals'. May the above described developments in standard-setting assist ICAI in achieving its Vision! ■

⁸ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁹ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

¹⁰ <http://www.ifac.org/publications-resources/exploring-growing-use-technology-audit-focus-data-analytics>

¹¹ <http://www.ifac.org/publications-resources/iaasb-data-analytics-video>

¹² <http://resource.cdn.icai.org/26032icaivision2030.pdf>