Enhanced Auditor's Report: An Analysis

Enhanced auditor's reports are already being issued in many countries including UK, Netherlands, Australia, Sweden, France, Brazil and Kenya. In India, Auditing and Assurance Standards Board (AASB) of the ICAI issued the new and revised auditor reporting standards in the year 2016, which require auditors to provide more transparent and informative reports on the companies they audit. These standards are: SA 700 - Forming an Opinion and Reporting on Financial Statements (Revised), SA 701 - Communicating Key Audit Matters in the Independent Auditor's Report (New), SA 705 - Modifications to the Opinion in the Independent Auditor's Report (Revised) and SA 706 - Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report (Revised). The implementation of these standards was deferred by one year in 2017 thereby making the new & revised standards applicable for audits of financial statements for periods beginning on or after April 1, 2018. The auditing environment is becoming increasingly complex and challenging. The objective of this article is to give an overview of the new/revised reporting standards and highlight the significant issues to be considered for implementation in the first year. Read on…

CA. Deepa Agarwal

The author is a member of the ICAI. She can be reached at deepa2580@gmail.com or eboard@icai.in

The new and revised auditor reporting standards have been issued in response to demand from users of financial statements, in the wake of the financial crisis, for more relevant information on audits. Perhaps the biggest concern raised by many stakeholders was that aside from the auditor's opinion, the pre-revised auditor's report was not very informative. What investors and others

require is a look into the 'black box' by having auditors share more information about their work, including how the auditor has addressed key risks and other significant aspects of the audit.

The aim of the new/revised reporting standards is to provide auditor's reports that increase the public's confidence in both the audit process itself and the financial statements of companies. Considering the regulatory regime, enhanced auditor reporting will improve communications between the auditor and investors, as well as between auditors and those charged with governance. The new auditor's reports are, therefore, meant to enhance the understanding of the audit of the financial statements among users — investors, analysts, regulators, suppliers, employees and governments.

Since the new/revised standards apply to March year end audits, management, audit committees and auditors would have already started preparing for their implementation.

New Structure and Other Enhancements to the Audit Report

The revision of SA 700 has led to a new structure of the audit opinion. With the new structure, the auditor's report begins directly with the 'Opinion' and the identification of the documents that have been audited. The users will value the audit opinion which is of most importance. Therefore, having this opinion stated upfront in the auditor's report is a good move in meeting user's needs. The centrepiece of the new auditor's report is a new Key Audit Matters (KAM) section for listed entities that will provide information about what the auditor believes are the most significant aspects of the audit of the most recent period. With this information the auditor's report has been transformed from a standard pass/fail opinion into a more meaningful and customised report.

Importantly, the new auditor's report will also include enhanced communications about *going concern* — another topic of significant interest to investors, regulators and others, in light of the financial crisis, with a requirement to disclose 'close calls' on going concern and the use of a clearly identified separate section where there is a material uncertainty related to going concern. The description of management's responsibility for going concern is intended to reflect the requirements of the applicable financial reporting framework, while the description of the auditor's responsibility reflects responsibilities under SA 570(Revised), Going Concern, which is required regardless of the applicable financial reporting framework.

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The *description of auditor's responsibilities* for the audit and *key features of the audit* have been enhanced and expanded.

The revised SA 700 permits additional voluntary information on the *definition or description of materiality* in accordance with the applicable financial reporting framework in the new audit report. Whilst there is no requirement to provide the amount of materiality that was considered by the auditor in the planning and performance of the audit, it is observed that in many jurisdictions across the world who have adopted ISA 700 (Revised), there are instances where the amount of materiality has been included in the auditor's report.

Investors and other users also recognise that there is an increasing amount of other information included in an entity's annual report which provides insight into a company, such as management commentary. So the AASB committed to "raise the bar" regarding auditor work effort and reporting on this other information, and issued the *revised standard* SA 720, *The Auditor's Responsibilities Relating to Other Information,* which is effective for audits of financial statements for periods beginning on or after 1st April 2018, the auditor's report is required to include reporting on auditor's work related to considering other information in an annual report.

SA 720(Revised) introduces new requirements and guidance with respect to the auditor's responsibilities for considering the consistency of the other information in an annual report with the financial statements and the auditor's knowledge obtained in the audit. *It also introduces new*

requirements with respect to the reporting of the results of the auditor's work on other information in the auditor's report. SA 720(Revised) do not cover the auditor's opinion on the financial statements, nor does this SA require the auditor to obtain audit evidence beyond that required to form an opinion on the financial statements. However, an interesting change in the revised standard is that the auditor's report shall include a separate section with a heading "Other Information" or other appropriate heading such as 'information other than the financial statements and Auditor's report thereon' in the following cases:

SA 720(Revised) introduces new requirements and guidance with respect to the auditor's responsibilities for considering the consistency of the other information in an annual report with the financial statements and the auditor's knowledge obtained in the audit. It also introduces new requirements with respect to the reporting of the results of the auditor's work on other information in the auditor's report.

- **In case of audit of a listed entity,** the auditor has obtained, or expects to obtain, the other information at the date of the auditor's report.
- **In case of audit of an unlisted corporate entity,** the auditor has obtained some or all of the other information at the date of the auditor's report.

With the new structure and the additional information (KAM, materiality, Other information, going concern) the auditor's report may run into five to six pages.

What Counts as a KAM?

SA 701 includes a judgment-based decision-making framework to help auditors decide which issues from the audit would count as KAMs. Out of all the matters on which they communicated with the company's management and audit committee, they will select KAMs from those matters that required "significant auditor attention." In most cases, KAM will relate to significant or complex matters disclosed in the financial statements, including areas of higher assessed risks of material misstatement, or areas that involved significant auditor and management judgment.

The concept is that these are the areas that were of greatest focus in the audit, and typically the areas of greatest risk for the audit as well. Where were the areas of subjectivity? Which areas required a significant application of judgment? The impairment — of an investment, of goodwill or of another intangible asset — as being likely to feature as a KAM, because of the significant amount of judgment involved with these. The nature of a KAM will also vary according to the industry sector the company operates in. Revenue recognition is likely to be a KAM for software and telecommunications companies, for example, because they have complicated revenue recognition policies. Mining companies, meanwhile, may have licensing rights to mine a particular piece of ground, but it can be difficult for them to determine the value of that license, as it will depend on the cash flows generated by the mine in future. Therefore, their audits are likely to focus closely on license impairments. Above all, for KAM to be considered relevant and useful for investors and other users, auditors must make sure that the information is as entity–specific as possible, and related to the facts and circumstances of the current-period audit.

One area that will probably be a KAM for most companies, whichever sector they operate in, is taxation. For a lot of businesses, tax is really complex. It's also an area where there is a high amount of litigation, as well as disputes between tax authorities and companies, so it often requires significant auditor attention.

The key principle is that description of a KAM should be clear, concise, understandable and entity-specific. It should explain why the matter was considered to be significant in the audit and how it was addressed. There should also be a reference to the related disclosure in the financial statements.

Significant Issues

One of the challenges with financial statements is that they are quite complicated and involve estimates, judgement and assumption in its preparation. As a result, the audit is also quite complex and requires the auditor's assessment of risks of material misstatement to those financial statements to drive the performance of the audit. In today's boilerplate auditor's report, it may not be possible for investors to understand where the greatest of those risks lie in the eyes of the auditor.

For this reason, a particular area of focus within the new standards will be the requirements of the new SA 701 which will highlight those issues that, in the auditor's professional judgment, were of most significance in the audit. Some of the significant issues that require consideration in the first year of implementation are as below:

Identification of KAMs – In some respects, the greatest challenge for auditors is figuring out when an issue is or is not a KAM. "Just because something is a big number doesn't mean it's a Key Audit Matter. And just because it's where we spent a large proportion of our efforts doesn't mean it's a Key Audit Matter either. A large transaction, such as the acquisition or disposal of a subsidiary, might fit into this category. It's not necessarily a Key Audit Matter, because, although it may have required considerable audit effort, it could be a really straightforward transaction. The same applies to other transaction such as share buybacks, where a very large number may be involved, but which can be very simple to audit. Further, it is important that the KAMs in the auditor's report cross-refer to the financial statements. If there were something in the auditor's report that was not in the financial statements, that may not look appropriate. The descriptions of the matters should complement, and not repeat or contradict, what has been disclosed in the financial statements, while providing the audit perspective on those matters.

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Writing KAM – Technical jargon or use of highly complex language is another trap that auditors need to avoid falling into; the use of inaccessible language is against the spirit of transparency that regulators expect, and is not in the public interest.

Going concern and KAM – Going concern may be identified as both a material uncertainty and a KAM. SA 570 says that, in the event that a material uncertainty is determined, the issues that give rise to the material uncertainty may be a KAM. But 'going concern' should not be both a material uncertainty and a KAM.

EOM and KAM – Some items may be identified as both an 'emphasis of matter' and a KAM. SA 706 says that an item that has been selected as KAM may not be considered for disclosure within an 'Emphasis of Matter' paragraph.

Number of KAMs – It could be another area of consideration. SA 701 does not mandate any number of KAM; however lengthy lists of key audit matters are contrary to the notion of such matters being those of most significance in the audit. In various international benchmark studies, there were two to three KAMs reported per company.

Reporting of KAM by a group auditor – Another issue to be focussed is on reporting of KAM by a group auditor since it is also applicable to audit reports issued on consolidated financial statements in addition to report issued on standalone financial statements for listed entities. Implementation guide to SA 701 issued by ICAI states that in a case where the parent's auditor is not the auditor of all the components to be included in the consolidated financial statements, the auditor of the consolidated financial statements should consider the requirements of SA 600, 'Using the work of another auditor'. The group auditor would be required to assess matters that in his professional judgement, are key audit matters from the perspective of consolidated financial statements.

Though there seems to be no mandatory requirement in SA 701 read with SA 600 to mandatorily send group reporting instructions to the auditors of unlisted subsidiaries to specifically seek response to KAM pertaining to these subsidiaries, however, since the group auditor would be required to assess matters that in his professional judgement, are key audit matters from the perspective of consolidated financial statements, the group auditor may seek response from component auditor if any key audit matter is required to be included for that component irrespective of applicability of SA 701 at the component level.

Disclosure of KAM

While SA 701 defines what must be disclosed within KAMs, it does not prescribe how KAM should be disclosed. Some of the good practices can be:

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- Disclosing the monetary amounts of the balances in the financial statements to which the KAM refers
- Providing a list of KAMs at the beginning of the report – this may led to better reading and comparability between companies.

Communication with the Audit Committee

So what can a company's audit committee expect from the introduction of KAMs? The good news is that they are not the headache that some might fear and do not affect the actual conduct of the audit. Nevertheless, audit committees should expect their audit firm to communicate with them early, and to communicate well, about the KAMs that are likely to be included in the auditor's report. This meant that audit committees were not presented with any unpleasant surprises late in the process.

The discussions between the audit committee and the auditor around the KAMs are actually "an opportunity for the audit committee to engage with the auditor." The benefits of KAM should be clearly looked into – disclosure of KAM stimulates better governance, supports better audit quality, encourages better corporate reporting. The increased engagement between the auditor and audit committee on the "selection" or "ranking" of significant audit matters, and discussions around how those matters will be described in the auditor's report and how they complement the financial statement disclosures, can provide new perspectives for audit committees and auditors. The reporting by auditor in relation to part of the financial statements may also lead companies to add to the disclosures in the financial statements thereby resulting into better financial reporting.

KAM – International Experience

KAM has been adopted in more than 110 countries including Mexico, Australia, Italy, France and Sweden. Earlier adoption in a number of countries – UK, Netherlands, South Africa, Australia.

The key KAM topics identified were:

- Goodwill (and related CGU assets such as intangibles and PPE)
- Revenue
- Taxation
- Acquisitions
- Provisions
- Inventory
- Estimates
- Goodwill (and related CGU assets such as intangibles and PPE)
- Valuation of financial instruments

Considering the new/revised reporting standards has been implemented internationally, the experience can be leveraged by the auditors to provide shareholders more transparent information and insights on the conduct of the audit, previously only viewed by those in the boardroom.

Conclusion

Audit quality continues to be a high–priority topic for the regulators and it is well reflected in the revised audit reports. Both auditors as well as board members, management, investors and other stakeholders need to balance the right level of information. Considering this is the first year of implementation of the revised/new reporting standards, significant efforts will be required to provide high quality information. The underlying question is whether KAMs would become boilerplate or continue to be shaped considering the nature and changes at the entity and their underlying businesses. ■

Perfection is not attainable, but if we chase perfection we can catch excellence. - Vince Lombardi