New Audit Reporting Requirements including Key Audit Matters (KAM)

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It is an established fact that nothing is constant except change. And the same is valid with our profession too. With changes in perception about audit, changes in accounting and auditing norms / methodologies, changes in regulatory requirements, etc., it is imperative to keep updating the audit report formats for an enhanced and appropriate reporting. Accordingly, Institute of Chartered Accountants of India (ICAI) has revised Standards on Auditing (SA) with respect to auditor's reporting namely SA 700, "Forming an Opinion and Reporting on Financial Statements", SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report". ICAI has also issued a new SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report". Further, in accordance with such revised / new reporting requirements, ICAI has also revised SA 570, "Going Concern" and SA 720, "The Auditor's Responsibilities Relating to Other Information". All these revised / new SAs are effective for audits of financial statements for periods beginning on or after April 01, 2018. However, for SA 570 the effective date is on or after April 01, 2017. These changes are in line with best globally accepted practices, for better understanding of auditor's report and for clearer demarcation of responsibility and accountability of the management of a Company and that of an Auditor. Read on to know more…

New Audit Reporting Requirements

An Independent auditor's report is an extremely important document since this is a measure of the reliability of the financial statements of the entity. Though the audit report is not an evaluation of whether the entity is a good investment or not and it is not an analysis of the entity's earnings performance, but this reflects on the reliability of the financial statements and is looked upon by the lenders, creditors, investors, regulators etc. While an audit does not by itself guarantee accuracy of the financial statements, it provides users with a reasonable assurance that an entity's financial statements give a true and fair view in conformity with the applicable financial reporting framework. Thus, it may be said that the auditor's report adds credibility to the financial statements prepared by the management of an entity. Following is the summary of the revised / new reporting standards;

SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements"	Represents the overarching standard for auditor's reporting in accordance with the SAs and includes the required elements of the auditor's report, and also specifies the contents of the sections for the opinion, basis for opinion, management responsibilities and auditor responsibilities.

SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report"	Includes the requirements and guidance for communicating Key Audit Matters (KAMs) – the centerpiece of the new auditor's report and the most significant change to auditor's reporting.
SA 705 (Revised), "Modifications to the Opinion in the Independent Auditor's Report"	Addresses how the elements of the auditor's report are affected when a qualified, adverse or disclaimer of opinion is expressed.
SA 706 (Revised), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"	Addresses the requirements for inclusion of Emphasis of Matter (EOM) and Other Matter (OM) paragraphs in the auditor's report, and has been updated to: • Explain the relationship of EOM and KAMs. • Remove reporting of material uncertainties related to going concern as a form of EOM reporting.

The aforesaid revision and new inclusion have resulted into additional elements in an auditor's report and changes in positioning thereof. The revised structure and sequence are summarised as under:

a. ***Title:*** Independent Auditor's Report.

b. ***Addressee:*** The auditor's report shall be addressed, as appropriate, based on the terms of the engagement or as required by law/ regulation. Normally, it is addressed to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

c. ***Auditor's Opinion: (Change – positioned upfront)*** The auditor's opinion is now required to be positioned at the **beginning of the audit report** and shall have the heading "**Opinion**." It shall incorporate the entity's name, statement that the financial statements have been audited, identify the title of each statement comprising the financial statements, refer to the notes including the summary of significant accounting policies and specify the date of, or period covered by, each financial statement comprising the financial statements.

Note:

i. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall use the words, "In our opinion, the accompanying financial statements **present fairly, in all material respects / give a true and fair view** (either of) […] **in accordance with [applicable financial reporting framework]**.

ii. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

iii. In an unmodified opinion it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

d. ***Basis for Opinion: (Change - now required for all auditor's reports irrespective if the report is modified or not)*** The Basis for Opinion section previously was required only when the auditor's opinion was modified. Now, this section will be required for all auditor's reports. It shall state that the audit was conducted in accordance with the SAs, refers to the section of auditor's report that describes the auditor's responsibilities under the SAs, **(new affirmative statement), *include***

a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities *in accordance with these requirements* (the statement shall refer to the Code of Ethics issued by ICAI) and state whether the auditor believes that the evidence obtained is sufficient and appropriate to provide a basis for the opinion.

Note:

Besides compliance with code of Ethics as aforesaid, compliance with the ethical requirement of the compliance framework shall also be stated.

e. ***Going Concern*: (*Change – new insertion as applicable*)** Where applicable the auditor shall report the same in accordance with SA 570 (Revised). Such reporting requirement may be bifurcated into 3 situations:

i. **Use of Going Concern Basis of Accounting is appropriate but a Material Uncertainty exists and adequate disclosure about the material uncertainty is made in the financial statements** - The auditor shall express an **unmodified opinion,** and the auditor's report shall include a separate section under the heading 'Material Uncertainty Related to Going Concern' to draw attention to the said note in the financial statement and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

ii. **Use of Going Concern Basis of accounting Is appropriate but a Material Uncertainty exists and adequate disclosure about the material uncertainty is not made in the financial statements** – The auditor shall Express a qualified opinion or adverse opinion, as appropriate in line with SA 705 (Revised), and in the basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

iii. **Use of Going Concern Basis of Accounting is inappropriate** - If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion in line with SA 705 (Revised).

f. ***Key Audit Matters: (Change – new insertion)*** A new insertion, reporting of Key Audit Matters (KAMs) section for audits of **listed entities** and circumstances when the auditor decides otherwise. The new 'Key Audit Matters' section is one of the focal points of the revised auditor's report and governed by new standard, SA 701. The same has been discussed later in the article.

g. ***Other Information: (Change – New insertion)*** Where applicable the auditor shall report in accordance with SA 720 (Revised), the Auditor's Responsibilities relating to other information. SA 720 (Revised) deals with other information (whether financial or non-financial) included in an entity's annual report. Pointers for same are as follows:

i. Responsibility to consider, whether there is material inconsistency between the other information and the financial statement or auditor's knowledge obtained in the audit, and respond appropriately when the auditor identifies

that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated.

ii. The auditor's responsibilities relating to other information apply regardless of whether the other information is obtained by the auditor prior to, or after, the date of the auditor's report.

iii. Other Information - Financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report.

iv. **When to report** – (a) audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information at the date of Auditor's report, (b) an audit of financial statements of an unlisted corporate entity, the auditor has obtained some or all of the other information same as point (a).

v. **What to report** – (a) a statement that management is responsible for the other information, (b) identification of other information, if any, obtained by the auditor prior to the date of the auditor's report; and additionally for an audit of financial statements of a ***listed entity***, other information, if any, expected to be obtained after the date of the auditor's report; (c) a statement that the auditor's opinion does not cover the other information, (d) description of auditor's responsibilities relating to reading, considering and reporting on other information as required by SA and (e) when other information is obtained prior to date of auditor's report either a statement that auditor has nothing to report or a statement that describes the uncorrected material misstatement of the other information (as applicable).

h. ***Responsibilities for the Financial Statements (management) - (Change – Additional Statement on Going Concern)*** – Apart from other previously applicable requirements, new descriptions of responsibilities relating to going concern is included in this section. The description of management's responsibility for going concern is intended to reflect the requirements of the applicable financial reporting framework. Pointers for same are as follows:

i. The auditor's report shall use the term that need not refer specifically to "management" but reference may also be given to those charged with governance (person responsible for the oversight of the financial reporting process) in line with legal framework.

ii. Auditor's report shall describe the management's responsibility for assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility shall include a description of when the use of the going concern basis of accounting is appropriate.

i. ***Responsibilities for the Financial Statements (auditor) – (Changes – additional statements)*** – In addition to earlier applicable requirements, this section has now been made **more detailed by including among others following statement that:**

i. reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. **(more defined)**

SA 700 (Revised) contains, following illustrative formats of Independent Auditor's Reports on Financial Statements in which may be referred for further guidance:

- ✓ Illustration 1 – An auditor's report on financial statements of a listed company prepared in accordance with a fair presentation framework
- ✓ Illustration 2 – An auditor's report on consolidated financial statements of a listed company prepared in accordance with a fair presentation framework
- ✓ Illustration 3 – An Auditor's Report on Financial Statements of an Unlisted Company Prepared in Accordance with a Fair Presentation Framework
- ✓ Illustration 4 – An Auditor's Report on Financial Statements of a Non-Corporate Entity Prepared in Accordance with a Fair Presentation Framework
- ✓ Illustration 5 – An Auditor's Report on Financial Statements of a Non-Corporate Entity Prepared in Accordance with a General-Purpose Compliance Framework

Key Audit Matter (KAM)

With a purpose to enhance the communicative value and to further strengthen the probity of the auditors reporting by providing greater transparency about the audit performed, ICAI issued new SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report". The new reporting SA is mandatorily applicable to audits of listed entities (whether equity or debt) and for unlisted entities the same will be applicable either optionally by auditor or where law or regulation requires communication of same. The KAM would result in the auditors clearly spelling out in their report; the most important matters they have dealt with during the audit, how they have responded to them and how they had concluded on them in forming their opinion.

Having KAMs in the auditor's report will make reader / user of financial statements clearly focus on the matters which are of significant risk and judgement. This might also result in increased focus by auditors on key matters indirectly resulting in an increase in professional skepticism and improvement in audit process.

What is KAM - Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. It shall be determined from the matters communicated with those charged with governance, which inter alia includes;

a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.

b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

c) The effect on the audit of significant events or transactions that occurred during the period.

Matters to be considered by the auditor in determining KAMs

KAMs are always selected from matters communicated with TCWG.

Significant risks

To determine a risk as significant, the auditor may consider;

a) Whether it is a fraud risk?

b) Complexity of transactions;

c) Significant related party transactions;

d) Subjectivity or measurement uncertainty; and

e) Significant events or transactions that are outside the normal course of business of the entity, or appear to be unusual in nature.

Significant judgements

The significant management judgement would include accounting estimates having high estimation uncertainty. The same would generally include

ii. misstatement can arise from fraud or error and either a) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements or b) description of materiality. **(New)**

iii. as part of an audit in accordance with SAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit. **(New)**

iv. A more detailed description of Audit and auditor's responsibilities therein as detailed in SA 700 (Revised). This approach results in a full description of the auditor's responsibilities in relation to specific matters, including fraud, internal control, accounting policies and accounting estimates, evaluating the overall presentation, structure and content of the financial statements. **(New/more detailed)**

v. A statement on the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information - SA 600 - Using the work of another Auditor (if applicable). **(New)**

vi. The auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit. **(New)**

vii. The auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards. **(New)**

viii. For cases where SA 701 is applicable – Statement that from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. **(new)**

j. ***Report on Other Legal and Regulatory Requirements*** – The manner of disclosure and presentation remains same as earlier applicable.

k. ***Signature of the Auditor - (Change- signing partner defined)*** – Among other things as previously applicable now the report is to be signed by the auditor **(i.e. the engagement partner) (earlier signing partner was not defined)** in his personal name. Further, going forward, as applicable from 1st July '19 onwards, it is mandatory to include Unique Document Identification Number (UDIN) which can be generated from ICAI website.

l. ***Place of Signature*** - The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

m. ***Date of Auditor's report*** - Shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements.

a) Matters under litigation
b) Allowances for doubtful debts / accounts
c) Inventory obsolescence
d) Warranty obligations
e) Depreciation / Amortisation method used
f) Outcome of long-term contracts
g) Goodwill and intangible assets valuation
h) Unlisted investments
i) Derivatives and other financial instruments
j) Provisioning towards NPAs / impaired financial assets
k) Taxation matters, etc.

Significant events and transactions

Some of the events and transactions which could have an effect on the audit could be:

a) Acquisitions / Business Combinations;
b) Liquidity and going concern issues;
c) Failed products, service lines, ventures, business segments or entities;
d) Changes in the industry where the entity operates, or in the supply chain;
e) Significant transactions with related parties;
f) Use of off-balance sheet finance and special purpose entities;
g) Persisting internal control weaknesses;
h) Regulatory issues;
i) Major litigation and contingent liabilities.

What is not KAM -

Communicating key audit matters in the auditor's report is not a substitute:

a) For disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation,
b) for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised).
c) for reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern or ;
d) for a separate opinion on individual matters.

How to report – The reporting section of KAM shall include a description of each KAM and a reference to the related disclosure (if any) in the financial statements and shall address;

a) Why the matter was considered to be one of most significance in the audit - It may be based on economic condition, new or emerging accounting policies or change in entity's strategy or business model.
b) How the matter was addressed in the audit – it may include individually or combination of aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement, a brief overview of the procedure performed, an indication of the outcome of such procedure or key observations with respect to the matter.

Further, even if there are no KAM to be reported; the fact has to be stated in the KAM section.

SA 701 highlights that a material uncertainty related to going concern is, by its nature, a KAM. These matters are to be reported in accordance with SA 570 (Revised), Going Concern. In the KAM section, reference to the basis for qualified/ adverse opinion or the material uncertainty related to going concern section should be given.

Number of Key Audit Matters

There are no defined number of KAMs to be given in the audit report. The same may be affected by the complexity of the entity, the nature of the entity's business and environment; and the facts and circumstances of the audit engagement. It is envisaged that there will be at least one KAM for an audit of a listed entity.

Documentation

SA 701 requires specific documentation requirements with regard to matters that

required significant auditor attention and the rationale for the auditor's determination as to whether or not each of these matters is a KAM. Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report or that the only key audit matters to communicate are those matters addressed by paragraph 15. Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter.

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Exception

a) Matters which are already reported in modified opinion para in line with SA 705 (Revised) or material uncertainty para as per SA 570 (Revised), need not be again reported as KAM however reference of the said paras can be given in KAM section.

b) The auditor shall describe each KAM in the auditor's report unless law or regulation precludes public disclosure about the matter or in extremely rare circumstances, the auditor determines that the matter should not be communicated because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Illustrative matters of KAM for various industries	
Industry	**Area of significance which may be reported as KAM**
FMCG & Lifestyle	Inventory position based on ageing and outdated fashion products
Retail	Management estimates of giving rebates, chargeback to distributors
Real Estate	Revenue recognition based on percentage of work completed and estimation of cost of constructions
Departmental Store	Brokerages/pilferages of inventory
Pharmaceuticals	Product Recall. Expiry with its impact on financial position
Hotels	Loyalty programmes
Bank / NBFCs	Non-performing assets, risk of frauds, asset provisioning, IT structure.
Other matters may be related to Impairment of assets, disputed taxes, goodwill impairment, frauds, expected credit loss etc.	

> For further insight of the nitty-gritty of the aforesaid SA's, one may refer to Implementation Guide to SA 701 and Implementation Guide on Reporting Standards [Revised SA 700, Revised SA 705 & Revised SA 706] issued by ICAI.

Conclusion

Though the above requirements have resulted into an expanded form of auditor's report but it has brought more guidance on the responsibility and accountability of personnel involved therein. With advent of time, we may further come across further changes which may altogether change the method and way of presentation of auditor's opinion or conclusion.

For further insight of the nitty-gritty of the aforesaid SA's, one may refer to Implementation Guide to SA 701 and Implementation Guide on Reporting Standards SA 700 (Revised), SA 705 (Revised) & SA 706 (Revised) issued by ICAI. ■

To live a creative life, we must lose our fear of being wrong. - *Joseph Chilton Pierce*