Key Audit Matters in Auditor's Report: An Overview

Reporting key audit matters in the auditor's report represents the most significant change in auditor's reporting responsibilities. Users of financial statements from countries like Australia, United Kingdom, Netherlands and certain other territories in Europe that have already implemented KAM, have responded positively to the enhanced reporting. Benefits of reporting KAM includes improved user's understanding of financial statements including clarity on areas of significant judgement/ estimates, greater communication between auditor, management and those charged with governance about financial statements and improved financial reporting. Read on to know more…

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1. Background

The Institute of Chartered Accountants of India (ICAI) issued a new standard on auditing (SA) 701 'Communicating Key Audit Matters in the Independent Auditor's Report' ('SA 701'). The new standard is effective for audits of financial statements for periods beginning on or after April 1, 2018.

The purpose of communicating key audit matters (KAM) is to enhance the communicative value of the auditor's report by providing greater transparency about the audit. Communicating KAM helps intended users in enhancing their understanding of entity and audited financial statements by providing additional information about areas of significant management judgment in the financial statements.

2. Applicability of SA 701

a) SA 701 is mandatorily applicable to audits of complete sets of general-purpose financial statements of listed entities (listed in India or outside India) for periods beginning on or after April 1, 2018.

b) SA 701 also applies for audit of unlisted entities in following situations :

i) when the auditor decides to communicate key audit matters in the auditor's report, or

ii) when the auditor is required by law or regulation to communicate key audit matters in the auditor's report.

c) SA 701 is not applicable in the following situations:

i) entity is in the process of getting listed at the reporting date. SA 701 applies to such entity from the financial year in which such entity is listed.

ii) listed entities which gets delisted during the reporting period and are not listed as at reporting date.

iii) audit of special purpose interim financial statements, tax financial statements or financial results under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

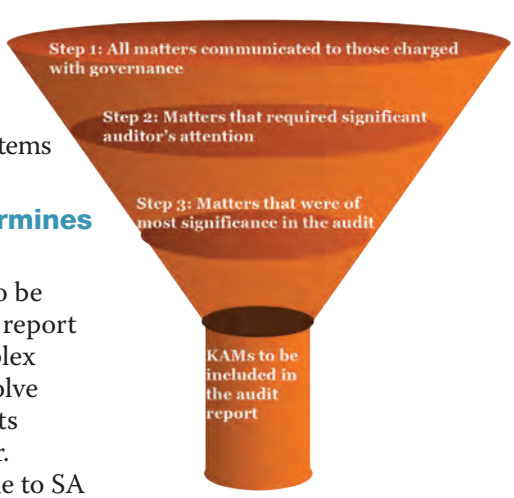
3. What are Key audit matters?

- Key audit matters are 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.

- KAMs will relate to areas involving significant estimates/judgements, significant related party transactions outside the normal course of business or significant or complex matters disclosed in the financial statements that would require auditor to involve experts or seek consultations.
- Examples of KAMs include valuation of goodwill and other long-term assets, valuation of financial instruments, difficult or unique aspects of revenue recognition, accounting for significant acquisitions, assessment of complex and judgmental taxation matters, provisions and contingencies, deficiencies in IT systems and controls, etc.

4. How auditor determines KAM?

- Determining KAM to be included in the audit report could be a very complex process and may involve significant judgements on the part of auditor. Implementation guide to SA 701 issued by ICAI provides a funnel approach to determine matters required to be reported as KAM in the auditor's report.
- The starting point would be the matters communicated to those charged with governance, which are filtered for matters that required significant auditor's attention and further filtered for matters that were of most significance in the audit of financial statements.
- The resultant matters after following the above stated funnel approach are reported as key audit matters in the auditor's report.



Let us understand each of the above steps in detail:

Steps in Determining KAM	Particulars
Step 1: All matters communicated with those charged with governance.	The starting point for determination of KAM to be included in auditor's report would be the matters communicated to those charged with governance.
Step 2: Matters that required significant auditor's attention.	• Matters communicated to those charged with governance are filtered to identify matters that required significant auditor's attention, i.e., matters that pose challenges to the auditor in forming an opinion or obtaining evidence that in his judgement was sufficient and appropriate under the circumstances. • While determining matters that required significant auditor's attention, the auditor shall take into account the following: a) Areas involving significant risks or higher assessed risk of material misstatements other than presumed significant fraud risks under auditing standards i.e. revenue recognition and management override of controls. b) Areas involving significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. c) Events and transactions having significant effect on the financial statements or audit. Examples of such events/transactions would include significant/unusual transactions with related parties, significant transactions outside normal course of entity's business, significant economic, accounting, regulatory or other developments influencing management's assumptions, judgement or estimates.
Step 3: Matters that were of most significance in the audit	• The matters determined at step 2 above are further sorted down to identify matters that were of most significance in the audit of current period financial statements. • Auditor may need to consider certain factors stated below in determining matters of most significance : a) Nature and extent of audit effort required, including the need for specialized knowledge and consultations outside the engagement team. b) Nature and severity of difficulties in applying the audit procedures, evaluating results of those procedures and obtaining relevant and reliable evidence. c) Importance of the matter to intended users' understanding of the financial statements and its materiality. d) Nature of the underlying accounting policy compared to other entities within its industry. e) Nature and materiality of corrected and uncorrected misstatements. f) Severity of any control deficiencies identified relevant to the matter. g) Impact on several related areas (example: long term contracts – impact on revenue recognition, litigation, contingencies). h) Matters shortlisted at this step are included as KAM in the audit report. Auditor would need to exercise appropriate professional judgement in selecting matters of significance considering size and complexity of entity and facts and circumstances of each individual audit. Determining too many key audit matters could be contrary to the notion of such matters are those of most significance in the audit of current period financial statements.

5. How are KAMs described in Auditor's report?

- Once the appropriate KAM(s) are determined after following above process, auditor needs to describe each KAM in the 'Key Audit Matters' section of the auditor's report stating the rational for considering such matter as KAM and how the matter was addressed in the audit along with appropriate reference, if any, to the related disclosure(s) in the financial statements.
- The description of KAM in the auditor's report would include:

a) Precise, concise and entity-specific explanation about the nature of the matter consisting of the specific audit issue or risk related to that account or line item forming the basis of considering such matter as of most significance to the audit.

b) Brief overview of procedures performed, aspects of the approach relevant to the matter or specific risk of material misstatement and indication of outcome of the procedures indicating how the matter was addressed in the audit.

6. Exemptions from reporting KAM:

In the following circumstances, SA 701 provides exemption from reporting matter determined to be a KAM in the auditor's report:

a) Law or regulation precludes public disclosure about the matter. For example, law or regulation may specifically prohibit any public communication that might prejudice an investigation by an appropriate authority into an actual or suspected illegal act like money laundering.

b) Auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The exemption stated at para (b) above is expected to be applied in extremely rare circumstances after auditor has discussed with management and those charged with governance (i.e., audit committee and/or board of directors) to understand and evaluate the potential adverse consequences of reporting such matter. In such situations, auditor may obtain a written representation from management/those charged with governance stating reasons for the potential adverse consequences and significance of such adverse consequences arising from reporting such matter.

7. Certain key consideration in reporting KAM:

Particulars	Guidance
Application of SA 701 in case of audit of consolidated financial statements (CFS).	• The group auditor would need to consider the requirements of SA 600 "Using the work of another auditor' and Guidance note on Audit of Consolidated Financial Statements while determining and reporting KAM in the auditor's report on CFS. • In case, where the group auditor is also auditor of all the components forming part of CFS, the group auditor would need to exercise professional judgement in determining KAMs to be reported in the auditor's report on CFS. • In case where the group auditor is not the auditor of all the components of the group, the group auditor should consider the requirements of SA 600.
Application of SA 701 in the case of joint audits.	• The joint auditors should identify KAMs for their respective area of responsibility. • In case of common areas of audit work, wherein all the joint auditors are jointly and severally responsible and the joint auditors carry out the audit work over such areas, the reporting of KAMs shall be made jointly by the joint auditors.

Application of SA 701 in the case of modified opinion on financial statements.	a) **Disclaimer of Opinion:** In case of disclaimer of overall opinion on the financial statements, auditor is not required to communicate KAM, unless law or regulation requires such reporting. b) **Qualified/Adverse Opinion:** • KAM is not required to be reported in respect of matters giving rise to adverse/qualified opinion on the financial statements. • Matters, if any, determined as KAM in addition to matters giving rise to adverse/qualified opinion are required to be communicated in the auditor's report. If no additional matters (other than those giving arise to qualified/adverse opinion) are determined as KAM, then auditor needs to state the said fact in the 'Key Audit Matter' section in the auditor's report.
Audit report with No KAM to be reported.	Except in case of exemptions permitted under SA 701 stated above, in very limited circumstances (E.g. listed entity with very limited operations), the auditor may determine that there are no KAM to be reported in the auditor's report and state such fact that there are no KAMs to be communicated in the auditor's report.

8. Conclusion:

- The enhanced reporting requirement to communicate key audit matters in the auditor's report is a big leap in the auditors' reporting responsibilities. The reporting on key audit matters in the auditor's report will result in greater transparency and facilitate enhanced understanding, to the users of the financial statements, of areas of significant judgement, complexity and estimates used by the management in preparation of the financial statements, how such areas were audited and the outcome of auditors procedures on those areas.
- Considering the significance of reporting KAM, the auditor, the management and those charged with governance of the entities would need to engage early with each other to evaluate the requirements of SA 701 and determine matters that qualifies to be reported as KAM as per the standard. ■