

The Extended Auditor's Report – Future of Audit Reporting



For some time now, there have been calls from users for the auditor's report to provide more than a pass/fail opinion on the financial statements. While the existing model of audit report is a valuable indicator of the reliability of the financial statements, there are concerns that it is lacking on communicating anything substantial about the audit or its findings. The matters identified and resolved by the auditor remained in their worksheets and do not come to the notice of users. In response to these calls, the ICAI has introduced new requirements on auditor reporting by issuing new SA 701, Communicating Key Audit Matters in the Independent Auditor's Report¹ which is effective for audits of financial statements for periods beginning on or after April 1, 2017.

To introduce further and/or consequential changes, the following revised standards have also been issued by the ICAI:

- Revised SA 700, Forming an Opinion and Reporting on Financial Statements



**CA. Archana Bhutani and
CA. Etisha Singh**

(The authors are members of the Institute. They can be reached at archana_bhutani@yahoo.co.uk.)

- Revised SA 705, Modifications to the Opinion in the Independent Auditor's Report
- Revised SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
- Revised SA 260, Communication with those Charged with Governance
- Revised SA 570, Going Concern

Without changing the scope of an independent audit, these changes open the door for the auditor to give users more insight into the audit and improve transparency. The new extended auditor's report will

¹ SA 701 is applicable to audits of complete sets of general purpose financial statements of listed entities, circumstances when the auditor otherwise decides to communicate key audit matters in the auditor's report or when required by law or regulation to communicate key audit matters in the auditor's report.

Standard

help enhance the nature of communications with stakeholders and enable users to recognise the value of audit.

The standards are aligned with the corresponding ISAs

SA 701, Communicating Key Audit Matters in the Independent Auditor's Report

A significant new requirement in SA 701 is the communication of 'Key Audit Matters' by the auditor in the audit report. Key Audit Matters (KAM) are those matters that in the auditor's professional judgement were of **most significance** in the audit of the financial statements of the current period. They are matters that required significant auditor attention in performing the audit—i.e. the areas that the auditor worried about and focussed on the most during the audit. The rationale behind reporting KAM is to highlight, 'through the eyes of the auditor', the most significant issues in the audit.

Identification of KAM

The identification of KAM involves the following stages:

- 1 The starting point of identification of KAM are the matters communicated to those charged with governance. Auditing Standards, especially SA 260 prescribes the matter that are required to be communicated to those charged with governance.
- 2 From the matters communicated to those charged with governance, the auditor would identify matters that require **significant auditor attention**.

In making this determination, the auditor shall take into account the following:

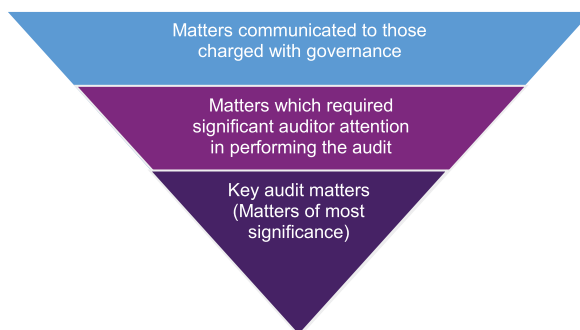
- Areas of higher assessed risk of material misstatement, or significant risks identified.
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

- 3 Key Audit Matters: The auditor should determine which of the matters identified at stage 2 above were of **most significance** in the audit of the financial statements. This will involve making a judgment about the

importance of each matter relative to others in the specific audit. The standard also provides guidance that will assist in making that judgment.

All significant matters identified at stage 2, and the rationale for determining whether each matter is a key audit matter, will need to be documented.

The following diagram summarises the filtering approach an auditor goes through when determining key audit matters for the audit.



For example, a quick review of the Rolls Royce Holdings plc (United Kingdom) audit report for the year ended December 15, 2015 reveals that of the 18 key risks identified, eight risks of material misstatement that had the greatest effect on audit were reported as KAM. These included pressure on and incentives for management to meet revised revenue and profit guidance, basis of accounting for revenue and profit in the Civil Aerospace business, bribery and corruption, presentation of 'underlying profit'. The audit report also include a description of application of materiality and an overview of the scope of audit.

Communicating KAM

KAM are described in a separate section of the auditor's report, under the heading 'Key Audit Matters', using appropriate subheadings for each KAM.

SA 701 requires that for each KAM identified, the auditor should

- explain WHY the matter was considered to be of "most significance" in the audit;
- describe HOW the matter was addressed in the audit; and
- provide a reference to any related financial statement disclosures.

The main value added is the "how" aspect and as part of this, the auditor may describe aspects of the engagement team's response to the assessed risk of material misstatement, a brief overview of procedures performed by the audit team, or key observations with respect to the matter, or some combination of these elements.

However, for communication of key audit matters to achieve their objective, effort will need to be taken to write them such that they are engagement specific (and not boiler plate), informative, concise and understandable to a non-auditor.

Other aspects

KAM not communicated- There are two circumstances under which a matter determined to be KAM is not required to be communicated in the auditor's report:

- Where law or regulation precludes public disclosure about the matter, or
- In extremely rare circumstances, where the auditor determines that the adverse consequences of the disclosure of KAM would reasonably be expected to outweigh the public interest benefit of the communication

Interaction with a disclaimed or modified opinion- SA 705 (Revised) prohibits the auditor from communicating key audit matters if the auditor disclaims the opinion (unless required by law or regulation). This seems to be primarily to avoid giving credibility to specific items in the financial statements. However, when the auditor issues a modified (qualified/adverse) opinion, the requirements of disclosing KAM in the auditor's report would still apply, provided that such matters are not the subject matter of modification of the opinion. When the matter identified as KAM is also the subject matter of modification, it should be described in the 'basis for modification' section of the report in accordance with SA 705, Modification to the Opinion in the Independent Auditor's Report and the KAM section should include a reference to it.

Going concern as a key audit matter- Matters giving rise to a material uncertainty casting significant doubt on the entity's ability to continue as a going concern are by their nature KAM. However, under the requirements of the new standard,

- these matters will not be described as KAM as these matters are to be included in their own

sections in the auditor's report in accordance with SA 570, Going Concern.

- the key audit matters section includes a reference to that other section.

If it is nevertheless determined that no such material uncertainty exists, then one (or more) matters relating to this conclusion may be considered a key audit matter. In such circumstances, the description of such key audit matters in the auditor's report could include aspects of the identified events or conditions disclosed in the financial statements—e.g. substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements and related mitigating factors.

Consistent with this, SA 570 *Going Concern* has also been amended to specifically require the auditor to consider whether, in the context of the applicable financial reporting framework the financial statements provide adequate disclosures when events or conditions that may cast significant doubt on the entity's ability to continue as a going concern have been identified but based on the audit evidence obtained, the auditor concludes that no material uncertainty exists.

Experience in other countries

Expanded auditors' reports have already been introduced in 2013 in the UK, where positive feedback indicates that users value the insights provided. Financial Reporting Council (FRC) has carried out survey of the experience in the two years since introduced which can be accessed on the links below:

- <https://frc.org.uk/Extended-auditors-reports.pdf>
- <https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Report-on-the-Second-Year-Experience-of-Extended-A.pdf>

"This is a huge change in the way auditors communicate with investors and other users. The preparation of these new style reports with so-called Key Audit Matters and other innovations will result in more intense communication with management and those charged with governance, such as audit committees. The public interest benefit hopefully will be better understanding of companies and their audits."

— Professor Arnold Schilder

Chairman, International Auditing and Assurance Standards Board

* Source: IFAC website

Standard

- More value for investors, companies and audit profession
- Challenges - additional time and cost, understanding of complex matters in KAM by users
- Requires change in mindsets

Changes are revolutionary

- SA 701 introduces the concept of key audit matters
- Changes to SA 700 amend the format and template wording of the report
- Changes to SA 570 in relation to communication on going concern matters

Changes to standards

- New section in the audit report to explain key audit matters (KAM)
- Report to include summary of KAM and audit procedures undertaken to address the matter
- Possible challenges - Identifying and communicating KAM, client specific reporting, implications for consistency (across industry), whether same matter can be a KAM every year

SA 701

- Audit report recasted; opinion to go first
- Clarification on going concern reporting
- More explicit statement on independence of auditor
- Enhanced description of the responsibilities of the auditor and of management
- New section to cover the audit work on other information in the annual report

SA 700

Communication between auditors, directors and management will be key- The changes are not intended to require the auditor to disclose information not provided by the entity, or to divulge price sensitive material. KAM include matters which have high assessed risk of resulting in a material misstatement in the financial statements and therefore where the auditor has placed heightened focus in the audit. Some of these matters can be potentially sensitive. The UK experience shows that such circumstances can be managed.

Time to change...

The current pass/fail model has its benefits because it is brief, clear, consistent and comparable and provides a quick scan of departures from the unqualified report. The new/revised standards retain this element while augmenting it with substantive informative matters. Aside from providing value to investors, the changes will enhance the quality, relevance and value of auditor reporting.

The new requirements are not intended to change the scope of a financial statement audit, and therefore should not affect the underlying audit work. They also do not directly impose any requirements on those charged with governance. However, considering that the auditor is required to communicate those matters it has determined to be key audit matters with those charged with governance, there will be increased interaction with the auditor regarding potential key audit matters.

Overall, it is expected that communicating key audit matters will provide additional information to users of the financial statements:

- to assist them in understanding such matters,
- to assist them in understanding the entity and areas of significant management judgment in the audited financial statements, and
- to provide them a basis to further engage with management and those charged with governance on matters related to the entity or the financial statements or its audit. ■