New auditor’s report requirement - Communication of key audit matters

This article aims to:
- Explain the concept of key audit matters that are part of new auditor’s report.

Summary

The Institute of Chartered Accountants of India (ICAI), on 17 May 2016, issued a new Standard on Auditing (SA) 701, Communicating Key Audit Matters in the Independent Auditor’s Report. This standard on auditing is expected to provide greater transparency about the audit that would be performed and increase in the communicative value of an auditor’s report.

SA 701 requires an auditor to describe in the auditor’s report of listed entities about the key areas it focussed on in the audit and the procedures performed in those areas.

SA 701 applies to audits of complete sets of general purpose financial statements of listed entities (with securities listed in India or outside India) and in circumstances when the auditor otherwise decides to communicate Key Audit Matters (KAMs) in the auditor’s report. It is also applicable in case the law or regulation requires an auditor to communicate KAM in the auditor’s report.

Recently, ICAI has also issued an implementation guide to SA 701 (implementation guide) in the form of Frequently Asked Questions (FAQs) and provided guidance on key issues relating to the application of SA 701.

This article aims to provide an overview of the new reporting requirement comprised in SA 701 along with highlighting the additional guidance provided by the implementation guide.

Key Audit Matters:
This is the most significant change introduced by the new requirements i.e. the auditor to include descriptions of key audit matters in the auditor’s report.

Effective date:
The new Standard on Auditing would be effective for audits of financial statements for periods beginning on or after 1 April 2018.

New style of audit reports:
Without changing the scope of an independent audit, the new Standard on Auditing opens the door for the auditor to give users more insight into the audit and improve transparency.
Inclusion of KAM - Significant change in the auditor’s report

- The most significant change introduced by SA 701 in the auditor’s report of listed entities is the communication of KAMs.
- KAMs have been defined to mean those matters that, in the auditor’s professional judgement, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with those charged with governance.
- As per the implementation guide, KAMs, in most of the cases, would relate to significant or complex matters disclosed in the financial statements. For instance, valuation of goodwill and other long-term assets, valuation of financial instruments, difficult or unique aspects of revenue recognition, assessment of impairment, taxation matters, accounting for significant acquisitions, etc.

Benefits of KAM

- Management and those charged with governance: Timely communication of KAM is likely to encourage management and those charged with governance to enhance or make new disclosures in the financial statements or other reports in light of the fact that the matter will be communicated in the auditor’s report. For instance, providing robust information about the sensitivity of key assumptions used in accounting estimates or an entity’s rationale for a particular accounting practice.
- Users of financial statements: KAM is expected to provide additional information that may assist users in understanding the entity and areas of significant management judgement in the audited financial statements.

Determination of KAM – a funnel approach

SA 701 and the implementation guide provided a funnel approach to determine which matters are required to be reported as KAM in the auditor’s report. According to the approach, following steps should be followed while determining a KAM:

1. Matters communicated with those charged with governance
2. Matters that required significant auditor attention
3. KAMs (matters of most significance)

(Step 3)

(Source: KPMG in India’s analysis, 2018 based on the provisions of SA 701 and the implementation guide)

- **Step 1**: KAMs should be identified from the matters communicated with those charged with governance. These matters could, *inter alia*, include the auditor’s responsibilities in relation to the financial statements audit and significant findings from the audit.
- **Step 2**: From the matters communicated to those charged with governance, identify the matters that required significant auditor attention. These primarily relate to matters that pose challenges to the auditor in forming an opinion or obtaining evidence that in his/her judgement was sufficient and appropriate under the circumstances.

While determining such matters, an auditor is required to consider the following:

a. Areas of higher assessed risk of material misstatement, or significant risks identified
b. Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as areas of high estimation uncertainty
c. Effect on the audit of significant events or transactions that occurred during the period. For instance, matters which had significant effect on financial statements or the audit and significant economic, accounting, regulatory, industry or other developments that impacted the management’s assumptions and judgements.

- **Step 3**: An auditor needs to determine which of the matters identified in Step 2 were of most significance in the audit of the financial statements of the current period.

Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit is a matter of professional judgement. Further, the number of KAMs to be included in an auditor’s report may be affected by the following:

- Size and complexity of the entity
- Nature of its business and environment and
- Facts and circumstances of the audit.

The implementation guide clarified that there is no threshold for the number of KAMs that need to be communicated by an auditor. Different entities in the
same industry can have different KAMs as the identification of KAM depends on the risk assessment process of the auditor and entity-specific conditions and circumstances. Similarly, it is possible for KAMs to be different in different years but cannot be entirely different.

SA 701 and the implementation guide provide certain factors that could be considered while identifying matters of most significance. These, inter alia, include:

  a. Areas where an auditor had more in-depth, frequent or robust interactions with those charged with governance on more difficult or complex matters
  b. Significant delays in management providing required information
  c. Management’s unwillingness to make or extend its assessment of the entity’s ability to continue as a going concern when requested
  d. Severity of control deficiencies.

Manner of communicating KAM

• The description of each KAM in the KAM section of the auditor’s report should include a reference to the related disclosure(s), if any in the financial statements, as to:
  a. Why a matter was considered to be one of most significance in the audit and therefore, determined to be a KAM and
  b. How the matter was addressed in the audit.

• It is important to note that communicating KAMs in the auditor’s report is in the context of the auditor having formed an opinion on the financial statements as a whole and not a separate opinion on individual matters reported as KAM.

Going concern as a KAM

• 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, Going Concern.

• In the KAM section, reference to the basis of qualified/ adverse opinion or the material uncertainty related to going concern section should be given.

Close call situations

• There could be events or conditions which may cast significant doubt on an entity’s ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists. These are generally referred to as ‘close call situations’.

• In such a case, an auditor should evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. These may be fundamental to the understanding of the entity and can be considered and reported as KAM.

Interplay between Emphasis of Matter (EOM), other matter and KAM section

• SA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter paragraphs in the Independent Auditor’s Report establishes mechanisms for auditors of financial statements of all entities to include additional communication in the auditor’s report through the use of EOM and other matter paragraphs when the auditor considers it necessary to do so.

• These paragraphs are presented separately from the KAM section in the auditor’s report.

• SA 701 and the implementation guide provided following guidance with respect to EOM, other matter and KAM section:

  a. **In case a matter has been determined to be a KAM:** The auditor is required to include the matter in the auditor’s report in accordance with SA 701. The auditor should not use an EOM paragraph or other matter paragraph to highlight the matter instead of the requirements of SA 701.

  b. **In case a matter is not determined to be a KAM as per SA 701 (i.e. it did not require significant auditor attention):** If the matter is fundamental to the users’ understanding of the financial statements, then the matter should be reported in an EOM paragraph in the auditor’s report in accordance with SA 706. For instance, in the following circumstances, an auditor would consider it necessary to include an EOM section:

    - An uncertainty relating to the future outcome of exceptional litigation or regulatory action
    - A significant subsequent event that occurs between the date of the financial statements and the date of the auditor’s report
    - A major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position.
Presentation of KAM

- KAM should be presented as a separate section after the basis for opinion section of an auditor’s report.
- In case KAMs identified relates to a modification, a statement to this effect is to be included under the KAM heading.
- In case, ‘material uncertainty relating to going concern’ section is required as per revised SA 570, then KAM section is placed after that section.
- Based on the auditor’s judgement as to the relative significance of the information included in the EOM paragraph, an EOM paragraph may be presented either directly before or after the KAMs section.

Types of KAMs not to be reported

- Under the following circumstances, a matter determined to be a KAM is not required to be communicated in the auditor’s report:
  a. Law or regulation precludes public disclosure about the matter.
  b. The 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. This will not be applicable if the entity has publicly disclosed information about the matter.
- In such a case, a written representation from management, and when appropriate, those charged with governance, could be obtained as to why public disclosure about the matter is not appropriate, including management’s view about the significance of the adverse consequences that may arise as a result of such communication.
- Apart from the above, there could be very limited situations (such as listed entity with very limited operations) where there are no KAMs to be communicated. However, in such a case also, KAM section will be given in the auditor’s report.