This article aims to:
- Illustrate sector-wise areas which could be potential key audit matters.

**Introduction**

International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* has been effective internationally for audits of financial statements for periods ending on or after 15 December 2016. Now in India as well, to keep the auditor’s report on Indian listed entities relevant to the stakeholders and provide them with insights into the audit process, Standard on Auditing (SA) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* is effective for audits of financial statements for periods beginning on or after 1 April 2018.

The auditor’s report – the principal communication from the auditor to users of the audited financial statements – is undergoing significant change around the world. A more informative auditor’s report is the most visible change in auditing in more than 50 years.

The United Kingdom (UK), Netherlands, South Africa, Australia, and other countries have already seen the new auditor’s report issued with positive reaction from all stakeholders.

The new auditing standard requires auditors to adopt a risk-based audit approach and communicate matters of most significance, as discussed with those charged with governance, during the course of the audit, as Key Audit Matters (KAM) in their audit report. Since the areas on which the auditor generally focusses are the ones in which the investors and other users have expressed interest (in particular, areas of the financial statements that involved the most significant or complex judgements by management), the reporting of KAMs provides additional transparency that stakeholders are looking for.
The end result is a new and improved auditor’s report that provides more transparency about important aspects of the audit, and better describes what an audit is and what the auditor does.

**Preparing for change**

Board of Directors, Audit Committee members, Chief Financial Officer and others responsible for preparing financial statements will need to understand the implications of the extended communication from the auditor, as well as the importance of their role in the process.

KAM is not a replacement of, or supplement to, management’s perspective embodied in the financial statements. The intent is not to ‘fill the gaps’ for disclosures viewed as incomplete or missing. The auditor’s consideration of the adequacy and appropriateness of disclosures is part of forming an opinion on the financial statements.

There often will be a link between KAM and areas of complexity or significant judgement in the financial statements. Such is the nature of auditing – risk-based approach that focusses auditor attention on the matters of greatest risk of material misstatement. The intent of KAM is to provide transparency for users as to HOW this affected the auditor’s approach to the audit. It is intended to highlight for users the matters that required most auditor attention so that users can then focus greater attention on how such matters were dealt with in the financial statements and annual report.

**Number of KAMs and detail**

KAM would be specific to an entity and the audit that was performed in order to provide relevant and meaningful information to users. The determination of KAM involves auditor judgement about the relative importance of matters that required significant auditor attention. Therefore, SA 701 includes a judgement-based decision-making framework to help auditors determine which matters, from those communicated with those charged with governance, are KAM. The level of detail in description of the KAM is a matter of professional judgement and may vary depending on specific facts and circumstances of the particular engagement.

For a listed entity in particular, many believe there would be at least one matter that received significant audit focus and discussion with the audit committee. A possible exception may be those circumstances where a listed entity has very limited operations and the auditor determines there are no KAM because there were no matters that required significant auditor attention. In these situations, the auditor’s report would indicate that there were no KAM to communicate.

The auditing standards therefore do not prescribe or limit the number of matters to be reported as KAM; practice to date has shown that the average number of KAM communicated falls somewhere between two and six.

While KAMs would vary from entity to entity, based on specific facts and circumstances, they are generally based on those items of financial statements that are significant to the entity as a whole. Based on our experience, companies in the same sectors may have certain KAMs which are similar, considering the risk assessment and importance of the sector specific issues to the financial statements of such companies.

This article aims to highlight potential areas where significant judgement and estimates are generally required and such areas could be considered as potential KAMs. Following are the sectors:
Key areas that could be considered as KAMs

**Automotive**

While the automotive industry is capital intensive, the competitiveness is driving consolidation, collaboration and development in the use of technology in the sector. It has witnessed continuous innovation in its products and services. Some of the areas in the financial statements that could be considered as KAMs include:

- **Goodwill and intangible assets**: Impairment assessment are expected to be complex and are likely to contain certain judgements and assumptions. Examples are value in use method, preparation of discounted cash flow forecasts, forecast of long-term growth rates and discount rates.

- **Receivables and allowances**: Entities may have different trends of rebate arrangements, and in many cases judgement would be involved in determining the revenue. Additionally, management’s estimate is involved in determining the expected credit losses after considering credit history of customers and current market conditions.

- **Inventories**: Valuation of inventories could be subjective due to inherent uncertainty due to the volatility in valuation of inventories based on changes in consumer demand as sector invests in continuous innovation.

- **Property, Plant and Equipment (PPE)**: PPE is another area which could involve high level of judgement while making assumptions about factors for assessing useful life, which can be inherently uncertain and could be subject to management bias.

- **Provision for warranty and recalls**: Computation of provision for warranties and recalls generally involve significant analysis of historical data with respect to the level of repair and returns, and estimation of costs in respect of future warranty claims and refunds. Given that the estimates are based on facts and circumstances that may change from time to time, this is considered to be an area of significant management judgement.
The sector includes construction companies, real estate developers, companies that hold properties for investment purposes such as malls, car park spaces, etc. and other companies providing construction and engineering services. For many of the companies, the properties held by them and inventories for their business activities form a significant part of their financial statements. Some of the areas in the financial statements that could be considered as KAMs include:

- **Investment properties**: A disclosure of fair value of the investment property needs to be provided in the balance sheet. This area involves judgement due to subjectivity of valuation techniques and sensitivity of assumptions used for fair valuing investment properties measured under the fair value model.

- **Inventories**: Inventories are measured at cost or net realisable value, whichever is lower. Assessment the net realisable value of long-term projects may involve inherent risks in estimation of future selling price and related construction costs.

- **Revenue**: Revenue recognised over time may require comparison of costs incurred till date with total costs estimated for the project or by a survey done by an external expert. Therefore, the area is likely to involve significant judgement.

- **Property, plant and equipment**: Impairment of PPE may require computation of recoverable amounts which could be sensitive to key assumptions applied, including those relating to the discount and terminal yield rates.

- **Litigations**: Real estate and construction companies may have various matters under litigation. This area involves assessment of the subject matter of litigation, management assessment of the merits of the litigation and the likely exposure on the company. Therefore, provision on subject matters under litigations are likely to involve significant management judgement.

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2. Currently, as per Ind-AS 40, Investment Property, investment properties are required to be measured at cost, however, the Institute of Chartered Accountants of India (ICAI) through an exposure draft issued in June 2018, have proposed an amendment to Ind-AS 40 to permit companies to adopt either a cost model or fair value model. This exposure draft is pending notification by the Ministry of Corporate Affairs.
**The consumer and retail sector includes companies providing retailing, food and beverage and other consumer goods and services. With an increase in e-commerce, the sector witnessed an increase in investments in intangibles. Some of the areas in the financial statements that could be considered as KAMs include:**

- **Goodwill and intangible assets:** Impairment of goodwill and intangible assets is a potential area of KAM because the assessment of goodwill requires the computation of value-in-use by preparing discounted cash flow forecasts for each cash generating unit to which goodwill has been allocated and comparing the net present value of the forecast cash flows with the carrying values of the related assets. The preparation of discounted cash flow forecasts is likely to involve exercise of significant management judgement, in particular in estimating future sales growth rates, expected margins and the discount rates applied.

- **Inventories:** In order to compute provisions for slow/non-moving inventories, there is a need to estimate demand of new products and the duration of product lifecycles in order to estimate the amounts of inventories which expected to be sold in the future. This area is expected to involve significant degree of management judgement.

- **Property, plant and equipment:** Impairment of PPE generally involves a number of complex assumptions, and in many cases will be required to be made for each operating unit individually.

- **Revenue:** Revenue being one of the key performance indicators is susceptible to errors and manipulation due to misstatement of timing of revenue recognition and measurement of revenue. High volume of individually small transactions, makes fraud/error detection difficult.

- **Receivables and allowances:** Allowance for doubtful debts requires the application of management judgement. Trade allowances and rebates given to customers are likely to involve estimates and judgements due to customer-specific contractual arrangements.

- **Indirect tax contingent liabilities:** Contingent liability disclosures for indirect tax require the management to make judgements and estimates in relation to the issues and exposures. Considering the complex nature of the tax regulations and jurisprudence make this a particular area of judgement.
The sector includes companies dealing in metals, chemicals, power, mining and other natural resources and engaged in manufacturing activities. Being a capital intensive sector, PPE and inventories pay a pivotal role in its development.

Some of the areas in the financial statements that could be considered as KAMs include:

- **Property, plant and equipment**: For the ENR sector, PPE is one of the quantitatively significant item in the financial statements. PPE could be considered as a potential area of KAM due to:
  - **Capitalisation of new projects**: Capitalisation of new projects generally involve significant judgement to determine internal and other costs incurred for the project that should be capitalised.
  - **Impairment assessment of PPE**: Impairment of PPE involves a number of complex assumptions and management judgement, particularly in estimating future selling prices for crude oil and natural gas (where prices for these products are fluctuating) future production profiles and determining appropriate discount rates.
- **Receivables and allowances**: Impairment allowances for bad and doubtful debts are determined based on management’s estimate of the expected credit losses, considering the payment history of the company’s customers, customer specific conditions and relevant current factors in terms of liquidity and profitability of customers. This area is likely to involve a significant degree of management judgement.
- **Goodwill and intangible assets**: Capitalisation of intangible assets developed internally involves significant judgement in both determining when the criteria for capitalisation are met and in identifying the relevant costs to be capitalised, and whether the criteria continue to be met for ongoing projects. Another area is impairment of goodwill and intangible assets as the exercise generally involves significant management judgement.
- **Inventories**: For companies in the metal industry, determining the physical quantity of in-process metal is complex, and requires certain specific procedures. Further, the result of these procedures may not be accurate. Therefore, the area involves significant management judgement and estimation while valuing inventory.
Life sciences

The life sciences sector includes companies that are engaged in the research and development of new medicines/molecules and production of medicines and other pharmaceutical ingredients. Some of the areas in the financial statements that could be considered as KAMs include:

- **Goodwill and intangible assets**: The inherent uncertainty of the performance of new/acquired products and sector volatility are likely to increase the risk of impairment. Impairment assessments require significant management judgement and complex estimation, which increases the risk of error or potential management bias.

- **Revenue**: Complex terms of contracts with distributors may require significant management estimation and judgement in determining the timing of revenue recognition and measurement of revenue. Where revenue is derived from several business segments, and agreements with customers contain more than one performance obligation, the management needs to determine the basis for allocating the consideration received between the separate performance obligations based on relative stand-alone selling prices. Determination of performance obligations and stand-alone selling prices are likely to involve judgements and estimates.

- **Receivables and allowances**: Impairment allowances for bad and doubtful debts are determined based on the management’s estimate of the expected credit losses, considering the payment history of the company’s customers, customer specific conditions and relevant current factors in terms of liquidity and profitability of customers. This area is likely to involve a significant degree of management judgement.

- **Acquisitions**: Acquisition accounting is considered a significant judgement area:
  a. Allocation of acquisition amount to fair value of identifiable assets and liabilities acquired, identification and fair valuation of previously unrecognised intangible assets acquired and recognition of goodwill/bargain purchase gain.
  b. Impairment assessment for intangible assets acquired are likely to require complex estimates.
The sector mainly includes companies that are providing information technology services. These companies witness complex revenue agreements with customers. Some of the areas in the financial statements that could be considered as KAMs include:

- **Revenue**: Companies in the technology sector earn revenue primarily from providing IT services, consulting and business solutions. The contracts of the company can be complex and are tailored specifically for each customer. Given the high level of automation, complexity of systems and the judgements involved while applying the revenue recognition standard, including the period over which to recognise revenue, recognition of revenue is considered as a key judgement area.

- **IT systems and controls**: Considering that companies in the technology sector have a high level of automation across processes, a high level of reliance is likely to be placed on a company’s IT systems and key automated controls.

- **Goodwill and intangible assets**: Due to the inherent uncertainty involved in forecasting and discounting future cash flows which forms the basis of the recoverability assessment and the subjectivity of key assumptions in impairment models, this is a potential area of KAM.

- **Taxation**: Significant judgements and management decisions may be made with regard to uncertain tax positions while computing taxation provisions. These matters are subject to management bias and may lead to litigations and disputes.
The healthcare sector includes hospitals, companies providing diagnostic services, and companies manufacturing and trading in medical devices. Many of the companies in the sector own the buildings and machines used by them in the normal course of business, hence it is considered as a capital intensive sector. Some of the areas in the financial statements that could be considered as key audit matters include:

- **Deferred tax assets on losses**: While recognising deferred tax assets, the Indian Accounting Standards require companies to forecast future taxable profits to determine whether they would be sufficient to recover all or part of these deferred tax assets. Considering the capital intensive nature of the sector, many companies (especially hospitals) take longer period to make themselves profitable. Therefore, significant amount of judgement is likely to be applied while analysing whether deferred tax asset can be recognised on business losses.

- **Impairment of investments**: Companies in this sector may have invested in equity and debt securities of their group entities (being subsidiaries, associates and joint ventures), which could be significant to the overall financial statements. These investments are required to be reviewed at the end of each reporting period to determine whether there is objective evidence of impairment. Computing the cash flows for such investments may involve the exercise of significant management judgement, and hence may be considered as a key audit matter.

- **Evaluating relationship between entities**: Ind AS 110, *Consolidated Financial Statements*, requires entities to consolidate those investees over which they have ‘control’, irrespective of the shareholding pattern of the investee. Considering the complexity of arrangements between entities, there is a significant amount of judgement involved in evaluating whether the investor controls/jointly controls the investee or has significant influence over it.
The media and entertainment sector includes television, print and other online media. It also includes art houses and publishing houses. Some of the areas in the financial statements that could be considered as KAMs include:

- **Amortisation of intangibles/inventories:** Generally the content procured/produced by media and entertainment companies is capitalised as inventory/intangibles. Considering the various rights attached to the contents (especially in case of online portals), it is imperative for the management to determine the manner and period of amortising the inventory and intangibles.

- **Revenue recognition:** Ind AS 115 is now applicable for revenue recognition for contracts with customers, accordingly, there are various aspects of the standard that need to be assessed, considering the nature of industry and the contracts, some of matters that involve significant management judgement are timing of revenue recognition, basis of allocation of transaction price to various performance obligations and recognition of revenue on a gross or net basis.

- **Receivables and allowances:** Customers may have different credit profiles and the timing of settlement of accounts receivable could be influenced by sector norms and the economic environment in which the customers operate. The allowances for doubtful debts are based on management’s estimate of the expected credit losses to be incurred, which is estimated by taking into account the credit history of the group’s customers and current market and customer-specific conditions.

- **Goodwill and intangible assets:** Due to the inherent uncertainty involved in forecasting and discounting future cash flows which forms the basis of the recoverability assessment and the subjectivity of key assumptions in impairment models, this is a potential area of KAM.
Transport, leisure and sports sector includes companies providing shipping, transport and logistic and tourism and hospitality services. With a growing emphasis on alternative transport modes, there has been a rapid increase in infrastructure investments and thus an increase in capital investments.

**Revenue:** Valuation and recording of customer loyalty points provided by various air and other travel companies, and deferment of revenue till redemption of loyalty points is a complex area. Certain companies in the ‘leisure’ sector such as theme parks obtain revenues from a number of different channels, such as admissions ticketing income, annual passes, spend in attractions. Due to the low value of individual transactions, it could be difficult to detect errors. However the high volume of transactions mean that systemic failure could lead to errors that aggregate into material balances.

**Property, plant and equipment:** Companies providing shipping, transport, logistics, tourism and hospitality services are capital intensive. Considering the economic environment in which they operate, impairment assessment should be performed on the trigger of impairment of PPE. Various judgements are involved while assessing impairment:
- **Identifying cash generating unit:** The hotel industry, especially larger group of hotels, that own many hotel units, face a challenge in identifying the Cash Generating Unit (CGU) while assessing impairment. Evaluating CGUs is a complex area and involves a significant degree of management judgement and estimation.
- **Impairment computation:** Judgements involved in computing recoverable amounts of PPE could be complex as they are dependent on assumptions about the future, such as revenue, growth rates and discount rates.

**Goodwill and intangible assets:** Impairment assessments prepared by management are complex and can be inherently subjective and require significant judgement and estimation, which increases the risk of error or potential management bias. Additionally, expenses incurred for internally developing intangible assets need to be assessed to determine whether they can be capitalised.

**Provisions and accruals:** Companies providing shipping, transport and logistics services, may face claims and litigations from regulators, customers and suppliers that arise during the normal course of business. The assessment of the provision for such claims involves estimates based on past claims experienced and recent claim developments. The ultimate claim amount is dependent on future external events, which are inherently uncertain and actual claims may, therefore, deviate from management estimations.

**Receivables and allowances:** Recoverability of trade receivables is could be another potential area of KAM as companies in this sector provide services to customers in various sectors such as oil and gas, construction etc. These customers have different credit profiles and the timing of settlement of trade receivables can be influenced by the individual customer/sector performance. Allowances for doubtful debts are based on management’s assessment of individual receivable items, which is estimated by taking into account customer-specific conditions, the repayment history of the customers and their on-going relationship.
Financial services

The financial services sector includes banks, non-banking financial companies and investment management funds. Many of these companies deal with investments and other financial instruments, the recognition and measurement of which is complex in the Ind AS environment. Some of the areas in the financial statements that could be considered as KAMs include:

- **Investments valuation**: Selection of the basis of valuation of investments is a potential area of KAM.
- **Receivables and allowances**: Significant judgement and assumption in recoverability of loan and impairment assessment based on the expected credit loss model. Another area of judgement is valuation of collateral which could have significant impact over recoverability.
- **Financial instruments**: Fair valuation of financial instruments is complex and involves significant accounting judgement.
- **Goodwill and intangible assets**: Estimation in fair value of goodwill and other intangible assets involves significant judgment and estimate and identification of cash generating unit’s for impairment

**Consider**

The inclusion of KAM in the auditor’s report is intended to highlight ‘through the eyes of the auditor’, matters of most significance and those that were subject to significant judgement by management and auditor in the course of audit.