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ABU DHABI ACCOUNTABILITY AUTHORITY

ADAA –Auditor Reporting briefing paper

Key Audit Matters by ADAA's Shurooq Elayan

December 2017

Background

Historically audit reports were short and contained a simple opinion paragraph only. In 2009 that changed as part of the IAASB's clarity project to reduce the expectations gap and audit reports became longer, but still generic containing a basic unqualified or qualified opinion.

After the financial crisis, investors and other users demanded more informative, useful, relevant and transparent auditor reporting. In May 2011 the IAASB issued a Consultation Paper 'Enhancing the Value of Auditor Reporting: Exploring Options for Change'. The result of this process is in 2015 the IAASB issued its new and revised suite of auditor reporting standards.

The result could be a revolution in auditor reporting, or it might not. The most notable change is the requirement for auditors of listed entities to communicate Key Audit Matters **(KAM)**. Which are those matters the auditor views as most significant reported to Those Charge with Governance. The auditor must provide an explanation of how the KAM were addressed in the audit.

The new and revised Auditor Reporting standards include:
ISA 700 (Revised) Forming an Opinion and Reporting on Financial Statements
ISA 701, Communicating KAM in the Independent Auditor's Report (New)
ISA 705 (Revised) Modifications to the opinions in the auditor's report
ISA 706 Emphasis of Matter Paragraphs
ISA 570 (Revised), Going Concern

They are effective for audits of financial statements ending on or after 15 December 2016.

Purpose of KAM

ISA 701 the purpose of communicating key audit matters is to: *"enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements".*

What are KAM?

ISA 701 (paragraph 8) defines KAM as: *"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."*

What KAM are not

KAM are not a substitute for: disclosures in the financial statements; issuing a modified opinion; or going concern disclosures required by ISA 570. Each KAM is not a separate audit opinion. The audit opinion remains on the financial statements as a whole.

How are KAM chosen?

The auditor considers matters communicated to those charged with governance (ISA 260). From these, the auditor assesses which required the most attention during the audit. ISA 701 gives a framework for making this determination:

1. *Areas of higher assessed risk of material misstatement, or significant risks identified.*
2. *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.*
3. *The effect on the audit of significant events or transactions that occurred during the period.*

There could be many issues arising in the audit. ISA 701 is explicit auditors should prioritise them and include only the issues that were most significant in the audit before concluding on what is a KAM.

What is disclosed?

In a separate section of the audit report, the auditor describes each KAM. Each is referenced to related disclosures in the financial statements and also:

- *why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and*
- *how the matter was addressed in the audit.*

Each KAM should be as specific as possible, and not generic. Descriptions of KAM should be succinct and balanced. The language used should be non-technical, understandable, and the auditor should avoid duplicating information disclosed in the financial statements.

The standard does not specify how many KAM are provided but warns: "*lengthy lists of key audit matters may be contrary to the notion of such matters being those of most significance in the audit"*. Professional judgement is required.

The amount of detail of work done is not prescribed but the standard provides suggestions:

- *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 procedures performed*
- *an indication of the outcome of the auditor's procedures, or*
- *key observations with respect to the matter.*

If the auditor has identified conditions which cast doubt over going concern, but audit evidence confirms that no material uncertainty

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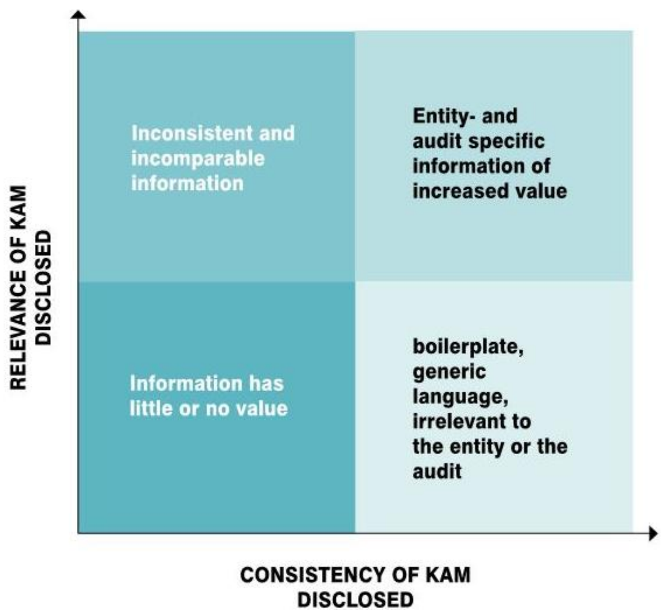
The chart explains the interactions between relevance and consistency of KAM disclosed:



Other changes to the audit report

The revised standards enhance the audit report in:

- Having the opinion first.
- Naming the audit partner.
- Separate section on Other Information.
- Management's responsibilities relating to Going Concern.
- Descriptions of TCWG's responsibilities relating to the financial reporting process.
- More detail on auditor's responsibilities including Going Concern.
- Statement on independence and ethics.

Revised Going Concern Standard

Along with ISA 701, ISA 570 has been revised. Under the revised standard, if the use of the going concern basis of accounting is appropriate but a material uncertainty exists and management have included adequate disclosures relating to the material uncertainties the auditor will continue to express an unmodified opinion. But the auditor must include a separate section under the heading 'Material Uncertainty Related to Going Concern' and:

- *draw attention to the note in the financial statements that discloses the matters giving rise to the material uncertainty, and*
- *state that these events or conditions indicate that a material uncertainty exists which 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.*

If a material uncertainty does not exist but, a 'close call' or 'judgement' exists, this 'judgement' will likely be disclosed within KAM in line with ISA 701.

Qualified opinions, emphasis of matters and disclaimers

Because of the introduction of ISA 701 which introduces KAM. Other audit reporting requirements have been revised to reflect the interaction with KAM. Some examples are:

- ISA 705 requires when a qualified or adverse opinion is given, KAM should still be provided in the audit report.
- If an adverse opinion is given, the auditor should be careful the KAM do not imply the adverse opinion on the financial statements is diluted in any way.
- If a disclaimer of opinion is given, the audit report should not include KAM.

Top KAM

The table lists the top KAM topics from three recent sources: KPMG's July 2017 publication titled 'KAM Auditor's report snapshot', FRC'Ss first post implementation review, and the latest IFIAR inspections findings survey:

	IFIAR link	KPMG link	FRC **link**
1	Internal controls testing	Goodwill and intangibles	Impairment Of assets
2	Accounting estimates including fair value measurement	Property, plant and equipment	Tax
3	Loan losses and loan impairments	Revenue Recognition	Goodwill impairment
4	Audit sampling	R&D costs	Management override of controls
5	Revenue recognition	Acquisitions	Fraud in revenue recognition

IFIAR findings show a strong correlation between the top KAM topics and the IFIAR inspection findings. This indicates whilst the most significant matters of the audit are being correctly disclosed under ISA 701, auditors need to do more, or better, work on them.

Going beyond

The Financial Reporting Council (FRC) has enhanced the requirements of the Auditor Reporting Standards they believe should lead to increased level of investor confidence in the audit. Extended explanations required on significant assessed risks of material misstatement and the audit response when describing each KAM.

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Along with reporting on KAM, auditors include an explanation of how the auditor applied the concept of materiality in planning and performing the audit, an overview of the scope of the audit and how such scope addressed each KAM and was influenced by the auditor's application of materiality.

Examples of KAM in Extended audit report

We have now had the benefit of a few reporting cycles and hence lots of examples of extended audit reports.

Some good examples can be found via the links below:

British Land
Hammerson
Marksandspencer
Pearson
Sage
Taylorwimpey
WPP

The FRC has now completed its second review of the implementation of extended audit reports and their findings can be read here link.

Conclusion

Currently Listed entities are within scope, however the explanatory material in ISA 700 (A43) re public sector entities states that *"public sector entities may be significant due to size, complexity or public interest aspects. In such cases, an auditor of a public sector entity may be required by law or regulation or may otherwise decide to communicate key audit matters in the auditor's report."*

And some countries have undertaken initiatives to widen the scope to public interest entities which ADAA welcomes.

The IAASB believe the new requirements will have several benefits. Prof. Arnold Schilder, IAASB Chairman comments: *"These changes will reinvigorate the audit, as auditors substantively change their behavior and how they communicate about their work."*

As long as the spirit of the standards are adhered to, auditor reporting has come into the 21st Century.

Accounting briefing papers are designed to assist readers in determining their accounting treatments. However, a briefing paper cannot provide a definitive answer since the treatment will depend on the facts and circumstances of each situation.

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