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Audit reporting enhancements and Key Audit Matters

How the Australian audit reporting changes may affect you

Executive summary

For years, the report that comes from the company's audit firm has been criticized as providing very little useful information for investors. Investors have been calling on the audit report to be enhanced from its pass/fail approach for some time. They have requested that the key areas identified in the course of the audit be explained and conclusions drawn on how the auditors were able to gain comfort.

To facilitate this, the International Auditing and Assurance Standards Board (IAASB) have undertaken a specific project to enhance the auditor's report, communication of their responsibilities with investors, and issues identified through the course of the audit.

This project's objectives included:

- enhancing the communicative power and relevance of the auditor's report through changes in its structure and content; and
- determining whether the reporting suite of International Standards of Auditing (ISAs) can be modified to accommodate evolving financial reporting regimes, while ensuring continuing communication of essential content.

In line with other countries, Australia is moving towards a more meaningful audit report for investors. Following extensive consultation, the Australian Auditing and Assurance Standards Board (AUASB) have approved the new auditors' reporting standards. The standards will be effective for periods ending **on or after 15 December 2016**.

Most of the changes in the auditor reporting standards apply to all audit reports, though the Key Audit Matters (KAMs) are currently being introduced for listed entities only. It is anticipated that all audit reports will eventually include a summary of KAMs.

These changes are revolutionary and the most significant to audit reporting in decades. We as auditors have the primary responsibility for implementing the requirements; the changes are relevant to and impact many other stakeholders. While there will be challenges, we have been preparing for the coming changes by commencing dry-runs of the new audit reports for many of our clients. This has provided valuable insights which we will share to assist you in embracing the changes.

In this document we will summarise what is changing with a focus on the introduction of the Key Audit Matters. We will show what the extended audit reports will look like and review examples already released to the Australian market by the early adopters. Finally we will summarise how you might be affected by the changes and detail those factors you should consider to successfully prepare for and implement change.

We hope that you find this communication to be a helpful starting point in understanding the new-style audit reports.

Section 1: What is changing

A new standard has been introduced:

- ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*. This details the concept of Key Audit Matters (KAMs), which we will look at in detail in Section 2.

There are also changes to the existing auditor reporting standards:

- ASA 700 *Forming an Opinion and Reporting on a Financial Report*, which amends the template wording and format of the audit report. We will explore examples of the new audit report in Section 3.
- ASA 720 *The Auditor's Responsibilities Relating to Other Information in Documents Containing an Audited Financial Report* which sets out requirements for the auditor to read other information included with the audited financial statements.
- ASA 570 *Going Concern* in relation to audit work required on going concern.

Finally, there are amendments to a number of other auditing standards so that the wording and requirements are consistent with changes introduced through ASA 700 and ASA 701.

Changes by section of the audit report	
Section	**Key change explained**
Audit Opinion	• Changes the structure of the report, including bringing the audit opinion to the front of the report
Key Audit Matters (KAMs) (Listed entities only)	• New section in the public audit report to explain Key Audit Matters (KAMs). KAMs are those matters which were of most significance in the audit of the current period financial statements. • Section to include a succinct description of the matter and a meaningful summary of how the matter was addressed in the audit. • Key audit matters outlined in the report should be specific and succinct in their description and provide a meaningful summary of how the matter was addressed during the audit
Going Concern	• Going concern explanation clarified. • New format in the audit report when a material uncertainty over going concern exists and is adequately disclosed in the financial statements. • Audit standard ASA 570 on work effort is also revised.
Other Information (in financial report and annual report)	• New inclusion in the audit report to cover auditor's work conducted on other information in the financial report / annual report
Auditor Responsibilities	• Changes to statement on independence, including which specific standards were followed in the application • Enhanced description of responsibilities of the auditor and management with option to move text on responsibilities to appendix or website.

Section 2: Key Audit Matters in focus

ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* is the most significant change arising from the amendments to the auditing standards. This introduces Key Audit Matters (KAMs).

Definition of Key Audit Matters

ASA 701 requires the auditor to summarise as Key Audit Matters (KAMs), within their audit report:

> **"Those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. The KAMs are only selected from matters communicated with those charged with governance."**

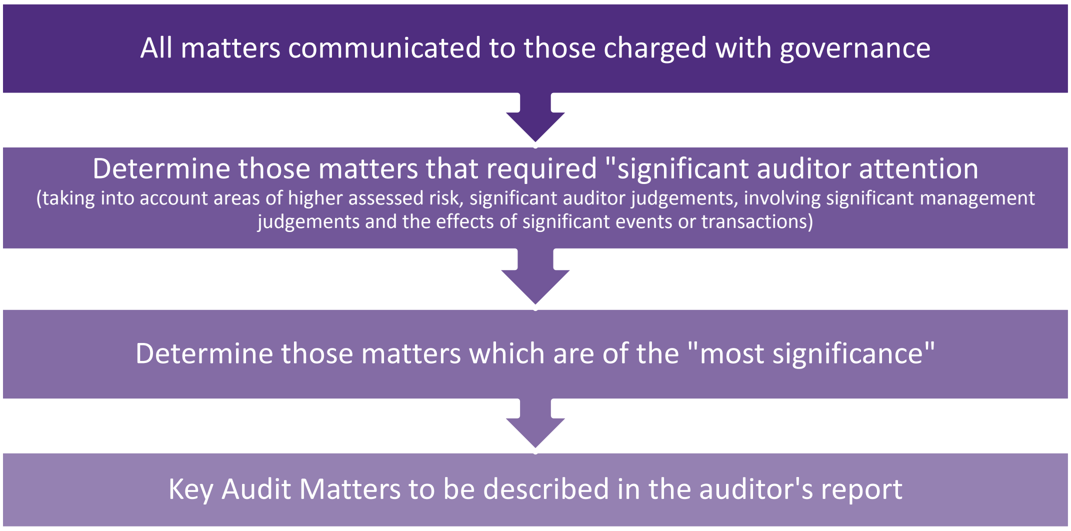
The objective of the KAMs is to:

- enhance the communicative value of the auditor's report by providing **greater transparency** about the audit performed and the accounting policies employed over certain risk areas
- provide additional information to intended users of the financial statements to assist them in understanding those matters that, in the **auditor's professional judgement**, were of **most significance** in the audit of the financial statements of the **current period**
- assist intended users[1] in understanding the entity and **areas of significant judgement** in the audited financial statements.

How the auditor determines the Key Audit Matters (KAMs)

- The auditor applies professional judgement in determining which matters to include in the audit report. While these matters will be drawn from discussions with the Audit Committee and those charged with governance (i.e. those matters communicated through our Audit Findings Report (AFR)), not all AFR points will be considered KAMs, as they will not all require "significant auditor attention".
- The concept of significant auditor attention recognises that an audit is risk-based. Matters that pose challenges to the auditor in obtaining sufficient appropriate audit evidence or pose challenges to the auditor in forming an opinion on the financial report may be particularly relevant in determination of Key Audit Matters.
- Areas of significant auditor attention often relate to areas of complexity and significant management judgement in the financial report, and therefore often involve difficult or complex auditor judgements.
- There may also be rare situations where no KAMs are identified.

Selection of the KAMs from those matters communicated to those charged with governance



1 ASA 701 provides for circumstances when an identified KAM is not included in the auditor's report, being only:
- when law or regulation precludes public disclosure; or
- in extremely rare circumstances, when the auditor determines that the adverse consequences of public disclosure would be expected to reasonably outweigh the public interest benefit.

Common area for KAMs

Based on UK adoption of extended audit reports, and those already published by Australian companies, common areas for KAMs include:

- going concern (close calls for EOM)
- revenue recognition (where significant judgements are applied)
- impairment risks (exploration, development assets or intangibles)
- legal, regulatory and taxation affairs
- acquisition and disposal of investments
- material weaknesses in internal controls that may lead to a material misstatement

Other key points on KAMs

Number of KAMs

Not all matters reported in the AFR need to be reported as a KAM. Keep in mind that a KAM is based on the auditor's judgement regarding matters of most significance in the audit of the current period's financial statements. The AUASB has indicated large listed entities should have no more than six (6) KAMs in any one reporting period.

Prior year KAMs

There is no requirement for the auditor to update KAMs included in the prior period. However, the auditor still needs to consider whether a matter reported as a KAM in the prior period continues to be a KAM in the current period.

Original information
The KAM section should not include any 'original information' about the company which has not otherwise been made publicly available.

KAM opinion
The KAM section should not contain or imply discrete opinions on the matter or separate elements of the financial report.

Reference to disclosure
The KAM shall be referenced through the relevant disclosure in the financial report.

Section 3: Example Audit Reports
Four (4) listed companies (Cochlear Limited, EDI Downer, QBE and ASX Limited) have early adopted the new standards ahead of the compulsory start date, the extended audit reports have been published in their 2015 financial statements.

Section 4: How you might be affected and critical factors for successful preparation and implementation of the changes
Though we as auditors have the primary responsibility for implementing the requirements, the changes are relevant to and impact many other stakeholders.

In order to successfully deliver the extended audit reports when they become a requirement for listed companies 31 December 2016 or 30 June 2017 year ends, we must work together now to ensure an effective and efficient solution.

We are proposing a 'dry run' for of our all listed Grant Thornton Audit engagements for the year prior to when the changes become mandatory, this has already been done for the 31 December 2015 and 31 March 2016 year ends. This dry run report will not be published or become publically available, but will give us an indication of both the time and cost burden which should be factored into the process, and will highlight any contentious issues or areas arising from our KAM identification process or in our proposed description of the KAM. As noted in Section 2, for some businesses, the KAMs will be consistent year on year.

Though for most of our clients, the dry-run is being conducted during the year-end audit, to get an idea of the time pressure etc. that we will experience during the real thing. Other clients have decided to schedule the dry run as a standalone exercise during a quieter time of year, though still long before the year end this becomes mandatory.

Based on the dry-run exercise, Management or Those Charged with Governance (TCWG) may decide to include enhanced disclosures in the financial statements or annual report relating to a KAM to address the matter that is included in the auditor's report (i.e. more robust sensitivity information regarding key estimates used in accounting estimates).

Timely, open and honest communication between the Auditor, Management and the Audit Committee is a must to ensure successful implementation of the changes.