IAASB®

AUDITOR REPORTING

March 2016

MORE INFORMATIVE AUDITOR'S REPORTS – WHAT AUDIT COMMITTEES AND FINANCE EXECUTIVES NEED TO KNOW

This publication has been prepared by Dan Montgomery, Chair of the Auditor Reporting Implementation Working Group and former Deputy Chair of the International Auditing and Assurance Standards Board® (IAASB). It does not constitute an authoritative pronouncement of the IAASB, nor does it amend, extend or override the International Standards on Auditing™ (ISA™). For further information, visit www.iaasb.org/auditor-reporting.

This publication was informed by interactions with the IAASB Consultative Advisory Group, and other stakeholders through the IAASB's outreach program. In 2015, three roundtables were held with audit committee members to discuss auditor reporting and audit quality. Ongoing liaison with the International Federation of Accountants' Professional Accountants in Business Committee also enables the IAASB to identify and consider issues relevant to audit committees and finance executives, and communicate with them about relevant IAASB matters.

Introduction

The auditor's report – the principal communication from the auditor to users of the audited financial statements – is undergoing dramatic 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 these new auditor's reports issued with positive reaction from all parties.

The IAASB approved the changes to the auditor's report in September 2014 and released its suite of new and revised auditor reporting standards in early 2015. This was the culmination of a process starting in 2006 with jointly-commissioned international academic research on user perceptions of the standard auditor's report. Along the way, others (including the UK, the European Union, United States, and the Netherlands) began parallel initiatives to change the way auditors communicate with investors and other users.

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

More than 110 countries around the world that use the ISAs are preparing for the change to the new style of auditor's report. Some countries have become early adopters but most will be applying the new requirements for December 2016 year ends, with the new auditor reports becoming prevalent in a number of major capital markets in early 2017. Many of the larger audit firms have, or are planning to, internally pilot test the proposals not only to develop their internal methodologies to support effective implementation of the ISAs, but also to raise awareness with management and audit committees of the entities they audit.

Audit committee members (along with full boards of directors) and CFOs or 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.

Not surprisingly, many questions are being asked about what investors and other users believe to be the "crown jewel" of the IAASB's new-style auditor's report – the communication of key audit matters (KAM).

Although the auditor's "pass/fail" opinion continues to be valued, the current auditor's report offers no insights into the audit process. KAM provides an opportunity to share the auditor's perspective with users on the matters that were of most significance in the audit of the current period. In addition, and importantly, these matters likely were the subject of the most robust dialogue with the audit committee.

What Questions Are Being Asked?

Stakeholder reaction to the new auditor's report has been broadly positive. Nonetheless, some questions and concerns have been raised along the way. A number of the most common questions and related concerns are addressed below.

1. Is the auditor taking on a management role when communicating KAM?

Throughout the course of the IAASB's public consultations and deliberations on revisions to the auditor's report, stakeholders clearly stated the need to maintain the separation of responsibility between preparers[1] and auditors.

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.

Clearly, there often will be a link between KAM and areas of complexity or significant judgment in the financial statements. Such is the nature of auditing – a risk-based approach that focuses auditor attention on 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's intended to highlight for users the matters that required the most auditor attention (i.e., "kept the auditor awake at night") so that users can then focus greater attention on how such matters were dealt with in the financial statements and annual report.

Experience in the UK (where the first extended auditor's reports were issued in late 2013), Netherlands, and early-adopting countries suggests that auditors are doing a good job in both avoiding the communication of "original information" about the entity in the auditor's report and not duplicating management's disclosures. The best examples effectively reference and leverage relevant disclosures in explaining why the auditor considered that matter to be one of most significance and how the matter was addressed in the audit.

1 For purposes of this publication, "preparers" relates to management or boards of directors with responsibility for preparation of the financial statements.

2. Will the communication of these matters publicly have an adverse effect on the relationship, and the candid dialogue, between the auditor and the audit committee?

A commonly expressed concern is that the communication of KAM may have a negative effect on the auditor's relationship with the audit committee, possibly leading to less candid or robust discussions on auditing and financial reporting matters. However, experience in the UK and elsewhere has shown that requiring auditors to communicate KAM enhances communications about those matters between the auditor and the audit committee, and increases attention by management and the audit committee to the disclosures referred to in the auditor's report.

Will there be occasional differences of opinion on which matters will be included, or their description, in the auditor's report? Yes, but experience to date indicates that this happens infrequently. It is virtually a non-issue when: 1) management, the audit committee and the auditor understand and support the objective of providing more transparency about the audit; and 2) there has been ongoing dialogue throughout the audit process, starting with the planning phase, about the matters that are the most likely candidates for KAM. Audit committees also benefit from seeing a draft of the auditor's report (at least the KAM section) as early as possible to get a feel for what the auditor may intend to say about the matters.

3. Will investors and other users view KAM as a "scorecard" on management's performance, including the relative aggressiveness or conservatism in management's accounting policies or judgments?

Existing auditing standards require the auditor to communicate with those charged with governance about certain matters. This includes the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. The intent of this communication is a candid discussion with the audit committee about any observations (including any concerns) the auditor may have about the entity's accounting practices or management's judgments or assumptions underlying critical accounting estimates.

The IAASB's public consultations revealed mixed reactions about including the auditor's views on these matters in the auditor's report. Some, particularly investors, believed that this additional transparency would provide the kind of auditor insight they desired. Others countered that it would be difficult for auditors to summarize the more detailed discussion that may take place with the audit committee, and that such a summary could be misinterpreted or misunderstood without the benefit of the context of the additional information provided to the audit committee.

Auditors are required to say something in the auditor's report about how a KAM was addressed. However, the specifics of the description are left to the judgment of the auditor. The auditing standards do not require either a lengthy description of the auditor's procedures, nor do they require an indication of the outcome of the procedures or a conclusion on the matter.

There are, however, some examples in practice of auditors providing a bit more detail about the audit response to the KAM, and going further to include an outcome or a conclusion of the audit process with respect to the matter. One example of outcome language from a highly acclaimed UK auditor's report: "… our assessment is that the assumptions and resulting estimates (including appropriate contingencies) resulted in mildly cautious profit recognition and we found no indication of conscious or unconscious bias." Another example from an early-adopter auditor's report in South Africa: "We concurred with the accounting and tax treatment of the transactions and found the disclosures in the consolidated … financial statements to be balanced."

Users generally welcome this additional transparency and insight from auditors. Others are concerned that outcomes or conclusions on individual matters can be misconstrued as separate opinions and detract from the auditor's opinion on the financial statements as a whole. The IAASB will continue to monitor practice and consider this and other aspects of extended auditor reporting in connection with its planned post-implementation review of the new reporting standards.

4. Will auditors limit the number of KAM communicated, or will they communicate more than necessary to avoid being second-guessed?

The determination of KAM involves auditor judgment about the relative importance of matters that required significant auditor attention. 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. Although, as expected, there is discussion with the audit committee and management on the matters to be communicated and the wording in the auditor's report, nothing to date indicates that the process is overly contentious. Further, there is no indication that auditors are either "padding the report" with extra matters or excluding matters that otherwise meet the definition of a KAM.

5. How will the auditor deal with significant matters that may not have been publicly disclosed by the entity?

The auditor reporting standards set a very high bar for communicating matters that meet the definition of KAM, as the overall aim of communicating KAM is to provide greater transparency to users of the auditor's report. Such matters must be included in the auditor's report unless law or regulation precludes public disclosure about the matter or, in extremely rare circumstances, 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.

It will bear watching how practice evolves regarding the communication of so-called "sensitive matters." These are matters that meet the definition of KAM (i.e., because they required significant auditor attention) but for which information has not been publicly disclosed by the entity. One example may be an alleged fraud or illegal act, which involved a significant amount of attention by the auditor, management and audit committee but was ultimately resolved without issue.

Another example may arise when underlying events or conditions exist that raise questions about the entity's ability to continue as a going concern, but management and the auditor conclude that no material uncertainty related to going concern exists.[2] In the absence of a conclusion that a material uncertainty exists, communicating a KAM related to a going concern "close call" may be difficult. However, the auditor

[2] A material uncertainty related to going concern is, by nature, a KAM but would be communicated in a separate required section of the auditor's report.

may include a KAM describing an underlying event or condition (for example, a significant debt obligation that will need to be refinanced) that received significant auditor attention and was disclosed in the financial statements. In addition, the revised auditing standard addressing going concern promotes greater auditor emphasis on disclosures in the financial statements in "close call" situations.

The auditor's decision not to communicate a "sensitive matter" would be informed by a full consideration of the facts and circumstances, along with discussions with management and the audit committee about the possibility of public disclosure by the entity about the matter.

6. Will the communication of KAM lead to boilerplate language in following years?

The concern about extended auditor reporting resulting in boilerplate language was expressed by many stakeholders during all stages of the IAASB's consultation process. And for good reason – it would defeat the principal objective of more informative auditor's reports.

The good news is that experience in the UK (which is now in its third cycle of using the KAM reporting model) suggests that auditors have taken to heart the concern about boilerplate – more importantly, the overarching objective to provide information that is relevant and useful for investors. Although citing room for further improvement, Citi Research noted in its September 2015 report on 2014-2015 UK auditor's reports: "On the whole, the quality of this year's auditor's reports has improved significantly. Generic risk disclosures have generally been dropped, and in many cases discussions of risk are much more granular and specific."

7. What has been the market reaction in those jurisdictions that have already adopted the new-style auditor's report?

Based on discussions with stakeholders in the UK, Netherlands, South Africa, Australia and elsewhere, reactions to the extended auditor's report – and KAM in particular – have been quite positive. Although many entities (and their auditors) may not have heard this favorable feedback directly from users, evidence exists to support the positive reactions. In the UK, for example, the Investment Management Association has given awards for the most insightful and innovative auditor's reports.

No direct reaction or comments may simply mean that KAM is reinforcing what investors already expected to be the case. In that sense, the auditor's communication of those matters may be adding to investor's confidence in the entity's financial reporting and the audit, and therefore may indeed be adding value to the process.

8. Will the new and more informative auditor's report add significantly more time and cost to the audit and the financial reporting process?

The new auditor's report represents one of the biggest changes in auditor reporting and communications in decades.

It is difficult to argue that there will not be some incremental effort (and cost) in the first year of implementation in particular. That said, empirical evidence in the UK and other countries suggests that the additional cost, if any, is minimal and can be effectively managed.

In most cases, for a recurring engagement, an experienced auditor will have a good idea of the areas that present the highest risk and complexity, and can signal upfront to the audit committee that these are likely candidates to be communicated as KAM.

This allows for discussion with the audit committee and management well before the conclusion of the audit about the KAM that may be included in the auditor's report and how the auditor may describe these matters.

9. Is there a link between the new auditor's report and audit quality?

It is hard to imagine that a new-style report that more fully describes the auditor's responsibilities and matters of most significance in performing the audit would not have at least some positive effect on audit quality. Some say it could do so simply by virtue of the auditor providing more transparency about what an audit is and the most significant aspects of the audit. Others are not convinced that providing additional information in the auditor's report, viewed by itself, will have a measurable effect on audit quality.

Determining – or measuring – the effect of extended auditor reporting on audit quality is as difficult and complex as the topic itself. Will it cause auditors to perform procedures substantially different from what was done in prior years? In most cases, probably not. But it may lead the auditor to stand back and ask: Are the judgments and assumptions that we describe as being significant to the auditing of the matter (e.g., a critical accounting estimate) consistent with the entity's disclosures about the underlying judgments made and assumptions used in formulating that estimate? Is the audit work we have done, and the related audit documentation, consistent with what we are telling users we have done to address the matter?

The interactions between the auditor and the audit committee also are a key contributor to audit quality. A candid two-way dialogue between the auditor and audit committee about areas of risk and the planned approach to the audit helps the audit committee exercise its important responsibility for oversight of the financial reporting process and the audit. A more informative auditor's report can further support the governance role of the audit committee by creating a better link between the role of the audit and the responsibilities of the audit committee and board. It sends a strong signal to users that the areas of emphasis of the auditor – which, in all likelihood, are or should be areas of focus for investors -- have been discussed with the audit committee.

Conclusion

Auditor reporting is changing around the world. Positive reactions from investors and other users, as well as other stakeholders, point to the increased value of additional transparency about the audit and areas of focus for the auditor. The IAASB – along with other standard-setters and regulators around the world – will continue to monitor these developments with a view toward considering whether further enhancements to the communicative value of the auditor's report may be needed or useful in the public interest.

For more information and updates on the Auditor Reporting project, visit the IAASB's website at http://www.iaasb.org/new-auditors-report

Key Contacts

Dan Montgomery, IAASB Auditor Reporting Implementation Working Group Chair: danmontgomery@iaasb.org

James M. Sylph, IAASB Auditor Reporting Implementation Working Group Co-Chair jimsylph@iaasb.org

Natalie Klonaridis, Principal, IAASB: natalieklonaridis@iaasb.org

Prof. Arnold Schilder, IAASB Chairman: arnoldschilder@iaasb.org

Kathleen Healy, Technical Director, IAASB: kathleenhealy@iaasb.org

About the IAASB

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

International Standards on Auditing™, International Standards on Assurance Engagements™, International Standards on Review Engagements™, International Standards on Related Services™, International Standards on Quality Control™, International Auditing Practice Notes™, Exposure Drafts, Consultation Papers, and other IAASB® publications are published by, and copyright of, IFAC®.

The IAASB and IFAC do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

The IAASB logo, 'International Auditing and Assurance Standards Board®', 'IAASB', 'International Standard on Auditing™', 'ISA™', 'International Standard on Assurance Engagements', 'ISAE™', 'International Standards on Review Engagements', 'ISRE™', 'International Standards on Related Services', 'ISRS™', 'International Standards on Quality Control', 'ISQC™', 'International Auditing Practice Note', 'IAPN™', the IFAC logo, 'International Federation of Accountants®', and 'IFAC' are trademarks or registered trademarks and service marks of IFAC.

Copyright © March 2016 by IFAC. All rights reserved. Written permission from IFAC is required to reproduce, store or transmit, or to make other similar uses of, this document. Contact permissions@ifac.org.

Published by: International Federation of Accountants®

International Auditing
and Assurance
Standards Board®

529 Fifth Avenue, New York, NY 10017
T + 1 (212) 286-9344 **F** +1 (212) 286-9570
www.iaasb.org