Comments of the Staff of the Auditing and Assurance Standards Board of the ICAI on the Exposure Draft of the Proposed ISA 701
Communication of Key Audit Matters in the Independent Auditor's Report

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General Observations:

I.1. As per ISA 701 (para 7), "*Key Audit Matters*" (KAM) are to be selected by the auditor from the matters communicated to those charged with governance (TCWG). This gives rise to following two issues:

(i) the users of the auditor's report would not be restricted to only those charged with governance. TCWG have greater and better access to the nature and extent of background of the matter included as KAM and also any further required therefor for better understanding the KAM. This would not be the case with the users of the auditor's report, other than TCWG. Thus, they may not be in a position to understand/ appreciate the KAM in the right perspective.

(ii) the users of the auditor's report (other than TCWG) would be large and having a varied interest in the entity and its financial statements *vis a vis* TCWG. Thus, it would be really difficult for the auditor to arrive at a decisions of KAM that would uniformly be of interest/ use to the users of the audited financial statements is not possible.

I.2. This ISA would require professional judgment to be exercised on numerous occasions but does not contain enough illustrative guidance for the auditors. Thus, we perceive following difficulties:

(i) Practical implementation difficulties from the auditor's perspective. The auditors might end up making inadequate/ excessive disclosures under KAM; and

(ii) Problems in the manner in which the ISA is/ is likely to be understood and assessed for appropriate implementation of the ISA by the external audit inspectors and/ or by the courts of law in cases of litigation against the auditors.

Examples:

i. Para 7, "Key Audit Matters" – Those matters that, in the auditor's professional Judgment, were of **most** significance in the audit of the financial statements of the current period."
ii. Para A2 – "Significance can be described as the relative importance of a matter taken in a context………"
iii. Para A5. Of the matters communicated with those charged with governance, users have expressed particular interest in understanding areas of **significant** **auditor attention** in performing the audit because they are often related to the areas of **significant management judgment** in preparing the financial statements. Users have also called for

greater transparency about **<u>significant judgments</u>** made by the auditor in forming the opinion on the financial statements as a whole.

iv. Para A8. The auditor's determination of key audit matters is limited to those matters of **<u>most significance</u>** in the audit of the financial statements of the current period, even when comparative financial statements are presented (i.e., even when the auditor's opinion refers to each period for which financial statements are presented).1 When comparative financial information is presented, as required by paragraph 9(a) the introductory language of the Key Audit Matters section is tailored to draw attention to the fact that the key audit matters described relate to only the audit of the financial statements of the current period, and may include reference to the specific period covered by those financial statements (e.g., "for the year ended December 31, 20X1").

I.3. IAASB also needs to assess whether the risk of subsequent litigation against auditors wrt disclosures under KAM in the event of any subsequent problems in the entity, would lead to over exercise of professional skepticism *vis a vis* exercise of professional judgment by the auditors while making disclosures under KAM. Over exercise of professional skepticism (on account of risk of professional liability) would result in excessive information being given under KAM whereas improper exercise of professional judgment would result in information under KAM being inadequate/ inappropriate.

I.4. IAASB also needs to assess the impact of inclusion of KAM (particularly, in the background of what has been mentioned in 3. above regarding over exercise of professional skepticism) on the length of the auditor's report. It is felt that in any case, KAM is likely to result in information overload in the auditor's report, leading to greater confusion among the lay readers, particularly, in the background of the undeniable "audit expectation gap".

I.5. It is also felt that once a matter communicated to TCWG has been resolved to the satisfaction of the auditors, the same should not be included in KAM.

<u>Paragraph Specific Comments:</u>

II.1. Para A2 – "The significance of a matter……………………the expressed interests of the intended users or recipients……………."

a) The term "*expressed interest*" is very open ended. To safeguard the auditor's interests, it needs to be clarified, at least, as to where and how such users should have "expressed" such interest.
b) Para 1 of ED-ISA 701 uses the term "*users*" whereas in para A2 the term used in "*intended users or recipients*".

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[1] See ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*.

- There a large difference between how the terms “users” and “intended users” are to understood and interpreted.
- Similarly, there is also a difference between users/ intended users *vis a vis* intended recipients.

IAASB needs to look into this and use a uniform terminology.

II.2. Para A3 – While ISA 320 as well as ED-ISA 701 proceed on these assumptions about the users of the financial statements, it should also be seen:

a) Whether in the securities/ investor protection laws commonly prevalent in developed/ developing economy, such assumptions for investors/ users of the financial statements have been duly recognized or not;
b) Whether the Courts of law (in cases of litigations against the auditors) given due consideration to these assumptions or not.

II.3. Para A9 – By definition, KAM is to be extracted from matters communicated by the auditor to TCWG during the audit of the financial statements. Thus, it would not be reasonable to expect the auditor to look into last year’s KAM, particularly, in cases where the previous year’s financial statements were audited by another auditor and the jurisdiction does not permit access to the audit working papers of the other auditors. Thus, in such a situation, by considering/ including previous year’s KAM for the current year KAM, the current year’s auditor would take responsibility of that previous year’s KAM also, which is not desirable.

II.4. Para A29 leaves it to the professional judgment of the auditor to decide the order of presentation of individual within KAM. It may be considered whether the auditor should bring out the fact of relative importance of matters within KAM in the auditor’s report since in the absence of any such statement either all the matters within KAM are likely to be understood as of being equal importance or by default having been arranged in the order of decreasing importance.

II.5 Para A43 and A46 deal with examples of “robust disclosures” being made by management in view of KAM. Guidance is needed on what constitutes “robust” disclosures *vis a vis* “adequate” disclosures, the latter being a term which is commonly used in accounting as well as auditing literature. For example, para 13.e of ISA 700 also talks of “adequate” disclosures. The fear of KAM should not be the driving force for the managements to make adequate disclosures. In any case, if prior to KAM disclosures were not “robust”, the auditor should have modified the audit opinion and not pushed the matter to KAM.