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EXPOSURE DRAFT: REPORTING ON AUDITED FINANCIAL STATEMENTS

Clarification or Confusion?

BY
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Across the world, changes have either been made or are in the process of being made to the auditor's report due to users' criticisms on the lack of relevance or insight provided by the Pass/Fail model of the report. Major accounting standard-setters and regulators in the world are in agreement that an expanded auditor's report is required to enhance the informational value to users by highlighting matters that are of most significance to the audit of an entity's financial statements.

The International Auditing and Assurance Standards Board (IAASB) issued an exposure draft (ED) on enhanced auditor reporting in July 2013. Comments for IAASB's ED were solicited and the new and revised standards on auditor reporting are expected to be issued in the second half of 2014. While the industry largely supports enhanced reporting by auditors, there were disparate views as to how such reporting can be made without causing confusion among the users of financial statements. The communication of key audit matters (KAM) and the need to comment about the going concern of the entity in a separate section of the auditor's report can pose an application challenge for both the auditor and management.

KEY AUDIT MATTERS: MATTERS FOR CONSIDERATION

Determining KAM

Paragraph 8 of the new ISA 701 provides the following guidance in determining KAM:

ISA 701

8. The auditor shall determine which of the matters communicated with those charged with governance are the key audit matters. In making this determination, the auditor shall take into account areas of significant auditor attention in performing the audit, including: (Ref: Para. A1–A14, A24)

(a) Areas identified as significant risks in accordance with ISA 315 (Revised) or involving significant auditor judgement. (Ref: Para. A15–A19)

(b) Areas in which the auditor encountered significant difficulty during the audit, including with respect to obtaining sufficient appropriate audit evidence. (Ref: Para. A20–A21)

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(c) Circumstances that required significant modification of the auditor's planned approach to the audit, including as a result of the identification of a significant deficiency in internal control. (Ref: Para. A22–A23)

Based on the above, identifying KAM for disclosure should not be an issue, but it is also precisely this that some respondents have concerns with as it might lead to over-reporting of KAM and cause confusion among users. Management and those charged with governance (TCWG) may have concerns over certain KAM which could be sensitive for disclosure or convey a misconception of failure in governance in the entity. This would lead to protracted debates among the auditor, management and TCWG, and the fear that over time, would lead to another boilerplate auditor's report.

Some respondents are of the view that paragraphs (b) and (c) seek to expand the identification of potential matters for KAM disclosure when it should not be the case. The view is that any area in which the auditor encounters significant difficulty

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The new and revised IAASB standards will bring about substantial changes on how auditors contemplate and approach communication with users of their reports. The current boilerplate auditor's opinion falls short in terms of providing useful information on the significant risks associated with the business of the entity.

or in which the audit plan requires significant modification need not necessarily be of significant risk, and they would have been ultimately resolved before the auditor issues his audit opinion. Otherwise, this would be a case of limitation of scope which will lead to a disclaimer of opinion if it has material financial impact.

Some respondents have also expressed concerns over the reporting of significant deficiencies in internal control under paragraph (c). Requiring the auditor to report on such deficiencies as a KAM may cause the auditor to disclose original information. The auditor may risk divulging information which is particularly sensitive to the company.

Removing paragraphs (b) and (c) will align IAASB's concept of KAM to those of the EU and UK which require more restrictive reporting to those "most significant assessed risks of material misstatements".

Guidance on matters "of most significance"

ISA 701.7 defines KAM as those matters that, in the auditor's professional judgement, are of most significance in the audit of the financial statements. The concept of "of most significance" will be challenging to apply in practice, despite ISA 701.A2 guidance on "an objective analysis of the facts and circumstances". Many respondents have called for more guidance on what constitutes areas "of most significance" in an audit.

Regulators such as the Canadian Public Accountability Board (CPAB) have noted from inspections that auditors often struggle with the identification of significant risks.[1] The nature and number of risks being identified are notably inconsistent among auditors. Without a definition of "significance", comparability between entities may become unfeasible.

Many respondents have expressed concern that the lack of guidance may result in inconsistent disclosure by auditors in the initial years. Their fear is that over time, directors and management are expected to be engaged in protracted debates with their auditors over language use and what is to be included as KAM, resulting in generic boilerplate disclosures. Interestingly, France has, since 2003, a similar requirement which requires auditors to report "justifications of assessments". According to France's National Accountancy Body (CSOEC) and National Institute of Statutory Auditors (CNCC), the auditor's report has become increasingly homogeneous over time.[2] In spite of that, they have commented that their system of reporting has proven to be useful.

Many respondents have also expressed concern that users will be confused by the difference between KAM and emphasis-of-matter (EOM) and other-matter (OM) paragraphs as there is presently nothing in their respective titles to distinguish the two sections.

Framework on reporting on KAM

Several respondents have commented that ISA 701 provides too much flexibility as to what should be included in the descriptions of individual KAM. In the four illustrations provided, only three provide overviews of the audit procedures performed. Of the three, only two provide some indication of outcomes of the auditor's procedures. Users may be confused as to why only certain audit procedures are mentioned in a KAM and may be left

[1] Comment letter from CPAB, 22 November 2013
[2] Joint comment letter from CSOEC and CNCC, 21 November 2013

guessing why no audit procedure is disclosed for another KAM. Inconsistency in disclosures of audit procedures and their outcomes may create confusion for users.

Many respondents have also expressed concern on the specific phraseology used in the illustrations. The choice of words used, such as “challenged management’s rationale”, may inadvertently decrease users’ level of confidence in financial statements. In addition, some of the words used, such as “we conclude” and “we did not find evidence”, can create a false impression that piecemeal opinion is being issued for each matter.

GOING CONCERN REPORTING: A MAJOR CONCERN

Many respondents have commented that boilerplate statements on going concern will be of limited value to users and can potentially increase expectation gaps. The proposed statements are confusing and are open to misinterpretation by less-informed users.

Going concern reporting is a matter that needs to be first addressed in the financial reporting framework, before being dealt with in the auditor’s report. Insisting on a mandatory audit comment on going concern may be viewed that the auditor’s obligation exceeds that of the obligation on management and TCWG in opining on this matter. The general feedback is that the extant ISA 570 on reporting going concern issues by exceptions is serving its purpose well.

On the proposed explicit statement, “neither management nor the auditor can guarantee the entity’s ability to continue as a going concern”, many respondents view such a statement as unnecessary. By including a caveat only on going concern and not on other parts of the auditor’s report may cause users to place undue reliance on other aspects of the audit. In particular, they may get a wrong impression that the level of assurance on the financial statements is absolute.

It is worthy to note that there is no similar requirement for going concern reporting in the US’s version of exposure drafts on auditor reporting.

CONCLUSION

The new and revised IAASB standards will bring about substantial changes on how auditors contemplate and approach communication with users of their reports. The current boilerplate auditor’s opinion falls short in terms of providing useful information on the significant risks associated with the business of the entity. However, one must be mindful that providing too much information especially in the auditor’s report can create undesirable anxiety to users who may not be so familiar with how the accounting and auditor world works. It may bring about changed behaviour on how management and TCWG view this enhanced reporting by their auditors. As is often the case, the hard work starts when one applies theory to practice.

Auditors would do well to start thinking about how they can explain this new enhanced auditor reporting to their clients and TCWG to allay any fears arising from greater transparency in reporting. **ISCA**

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