

# FOCUS

AUDITOR REPORTING





# SHAPING AUDITORS' COMMUNICATION

## IAASB's Exposure Draft Heralds a Sea Change in Auditor Reporting



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he much-awaited exposure draft (ED) is finally out – after more than a year from the initial proposal to enhance auditor reporting. In June 2013, the International Auditing and Assurance Standards Board (IAASB) unanimously approved for exposure a set of proposed International Standards on Auditing (ISAs) which aim to

improve the existing auditor's report. The *ED Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*, was released a month later and is currently open for comment till 22 November 2013.

The current auditor's report, mostly a standard one-page document presenting an opinion on the financial statements, has been a topic of intensive discussion for several years. As early as 2006, research commissioned by IAASB had found that users want the auditor's report to reveal more about the entity and the audit itself. This call for change intensified following the



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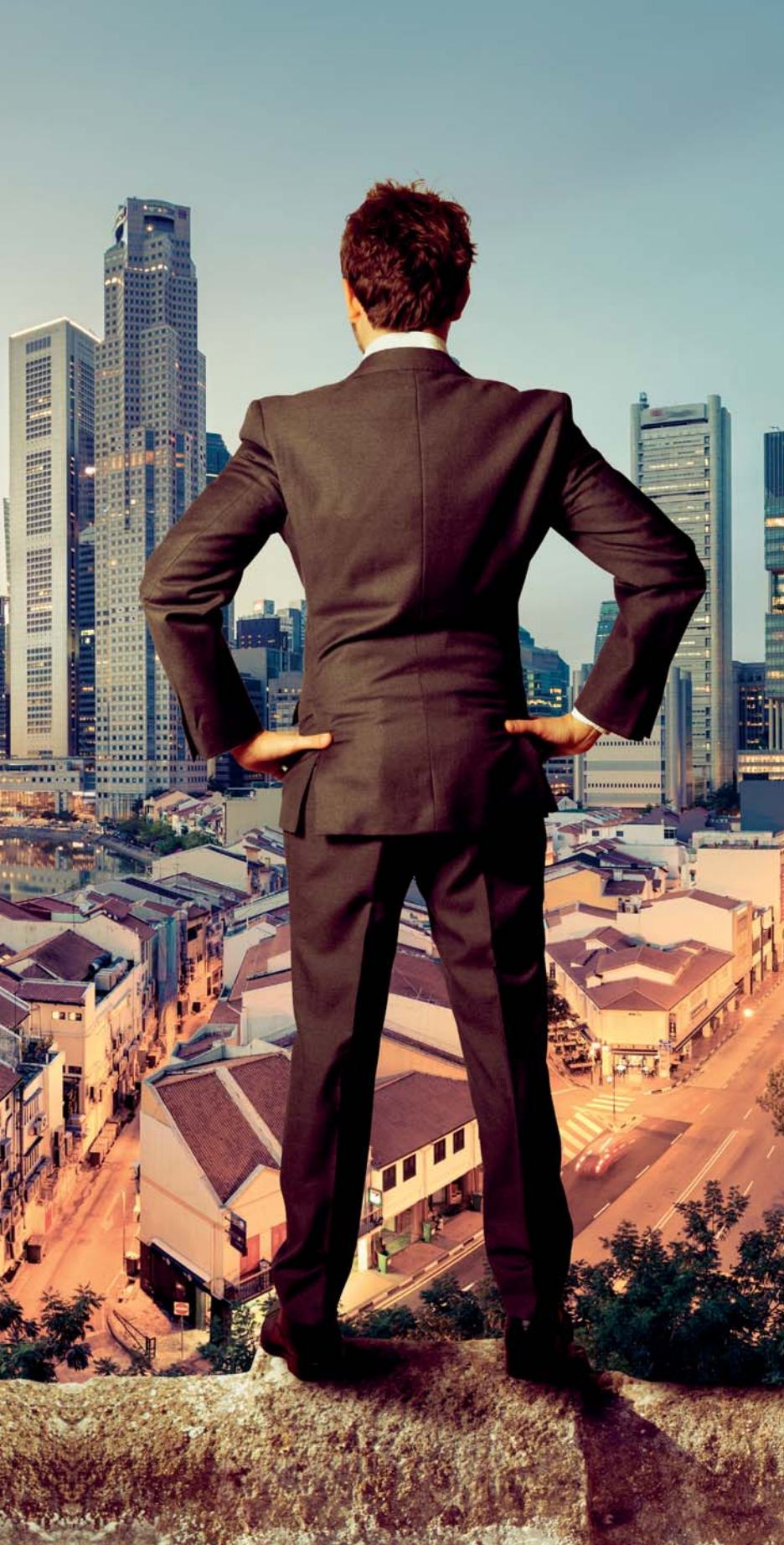
2008 financial crisis. However, when IAASB first released its proposal on improvements to the auditor's report in June 2012, reactions were mixed, with stakeholders supporting IAASB's intent and efforts but expressing concerns about the impact on audit cost and liabilities.

While IAASB upheld the original intent to make the auditor's report more relevant to users, it did not ignore some of the critical concerns raised. IAASB refined its initial proposal and proposed changes to five ISAs and developed a new ISA (refer to the box for list of

**IAASB refined its initial proposal and proposed changes to five ISAs and developed a new ISA. In a nutshell, the ED aims to increase transparency about the audit and to provide information of interest to users while clarifying the respective responsibilities of the auditor, management and those charged with governance.**

PROPOSED ISAs	NEW REQUIREMENTS
Proposed ISA 700 (Revised) <i>Forming an Opinion and Reporting on Financial Statements</i>	Establishes new required reporting elements: <ul style="list-style-type: none"> <li>• Basis for Opinion section – includes an explicit statement of auditor independence and the source(s) of relevant ethical requirements</li> <li>• Going Concern section</li> <li>• Key Audit Matters section</li> <li>• Other Information section</li> <li>• Improved description of responsibilities of auditor and key features of the audit</li> <li>• Disclosure of name of engagement partner</li> </ul>
Proposed ISA 701 <i>Communicating Key Audit Matters in the Independent Auditor's Report</i> (a new standard)	Establishes requirements and guidance for the auditor's determination and communication of key audit matters
Proposed ISA 260 (Revised) <i>Communication with Those Charged with Governance</i>	Establishes increased communication between the auditor and those charged with governance, including: <ul style="list-style-type: none"> <li>• Significant risks identified</li> <li>• Circumstances that require significant modification of the auditor's planned approach</li> </ul>
Proposed ISA 570 (Revised) <i>Going Concern</i>	Establishes auditor reporting requirements relating to going concern, including: <ul style="list-style-type: none"> <li>• Auditor conclusion on whether management has used the going concern basis of accounting appropriately</li> <li>• Statement as to whether a material uncertainty affecting going concern has been identified</li> </ul>
Proposed ISA 705 (Revised) <i>Modifications to the Opinion in the Independent Auditor's Report</i>	Clarifies how the new required reporting elements are affected when the auditor expresses a modified opinion
Proposed ISA 706 (Revised) <i>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report</i>	Clarifies the relationship between Emphasis of Matter paragraphs, Other Matter paragraphs and the Key Audit Matters section of the auditor's report
Proposed Conforming Amendments to Other ISAs	Key conforming amendments include: <ul style="list-style-type: none"> <li>• Requirement to state intent to communicate key audit matters in the engagement letter when they are communicated on a voluntary basis</li> <li>• Requirement to document auditor's determination of key audit matters</li> </ul>





proposed ISAs). In a nutshell, the ED aims to increase transparency about the audit and to provide information of interest to users while clarifying the respective responsibilities of the auditor, management and those charged with governance.

## **NEW SECTIONS IN THE AUDITOR'S REPORT**

The ED proposes a total of three new sections to be included in the auditor's report – key audit matters, going concern, and other information.

### **NEW SECTION 1: KEY AUDIT MATTERS**

One of the most significant changes introduced by the ED is the *Key Audit Matters* section. IAASB's initial proposal called for an auditor commentary section to highlight matters likely to be most important to users' understanding of the audited financial statements or the audit. However, feedback indicated that the auditor commentary would be too subjective as it might imply that the responsibility to determine matters most important to users' understanding of the financial statements lies with the auditors. This could potentially cause the auditor's role to be confused with that of management. Therefore, the *Key Audit Matters* section has been introduced to replace the auditor commentary concept. This section is intended to help users of the financial statements gain a better understanding of the audit and for the auditor to highlight areas of focus in the audit in the auditor's report.

Key audit matters are defined as matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. They should be determined according to the following criteria:

- 1. Matters which had been communicated to those charged with governance** However, key audit matters do not need to represent all the matters discussed with management and those charged with governance.

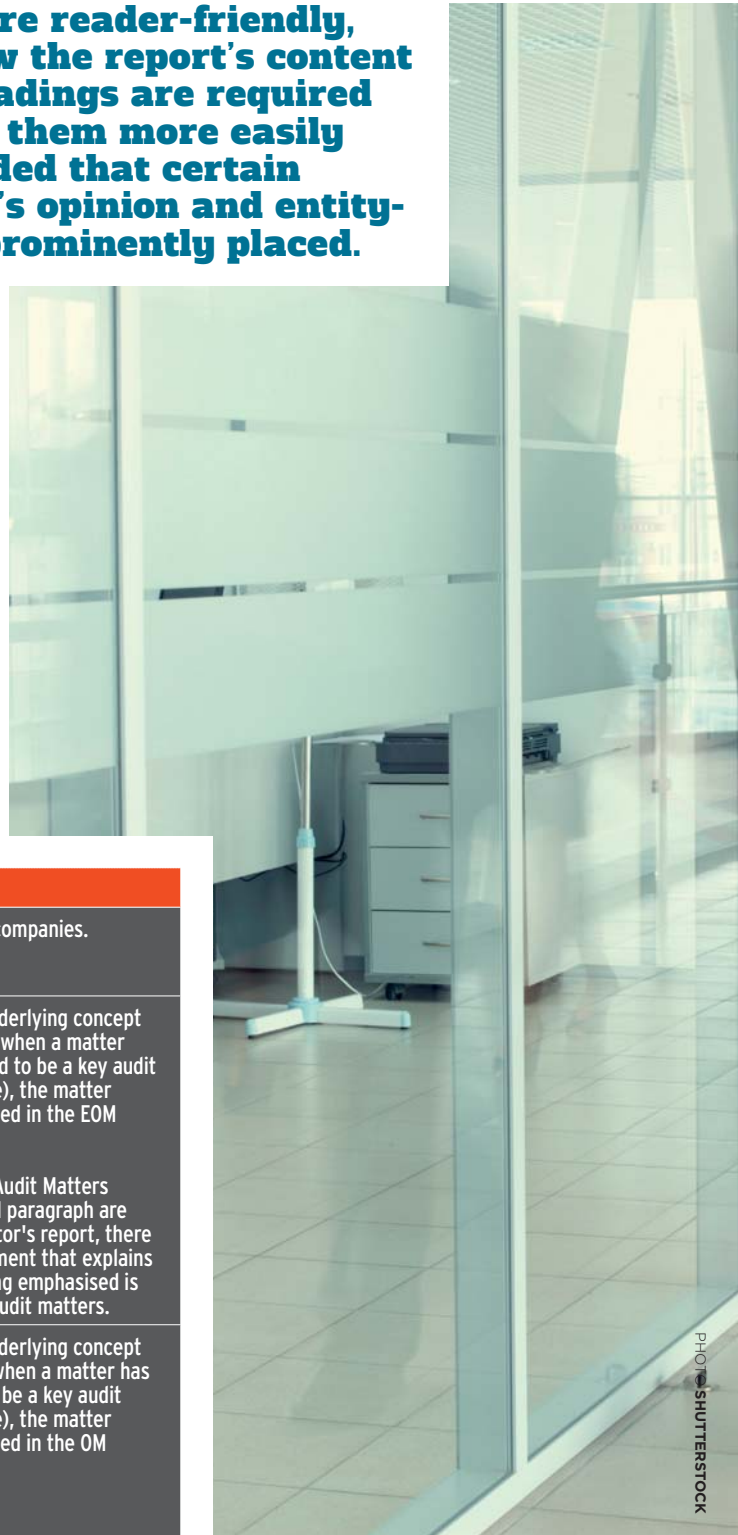


**To make the auditor's report more reader-friendly, the ED contains guidance on how the report's content should be organised. Specific headings are required for the various sections to make them more easily identifiable, and it is recommended that certain information, such as the auditor's opinion and entity-specific information, should be prominently placed.**

**2. Matters which required significant auditor attention**

If the auditor had to exercise significant judgement or encountered significant difficulty in certain areas, those areas may be considered key audit matters, for example, valuations that involve significant measurement uncertainty or assumptions that are affected by future market and/or economic conditions.

The *Key Audit Matters* section must be included in the auditor's report for audits of listed companies. For non-listed companies, its inclusion is left to the auditor's discretion, unless required by law or regulation.



	CURRENT	PROPOSED
Key Audit Matters	Not required.	Required for listed companies.
Emphasis of Matter (EOM)	EOM is included when auditor considers it necessary to draw users' attention to a matter presented in the financial statements that is of such importance that it is fundamental to users' understanding of the financial statements.	No change in the underlying concept of EOM, except that when a matter has been determined to be a key audit matter (if applicable), the matter should not be included in the EOM paragraph.  When both the Key Audit Matters section and the EOM paragraph are included in the auditor's report, there needs to be a statement that explains that the matter being emphasised is separate from key audit matters.
Other Matter (OM)	OM is included when the auditor considers it necessary to communicate a matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, which is not presented in the financial statements.	No change in the underlying concept of OM, except that when a matter has been determined to be a key audit matter (if applicable), the matter should not be included in the OM paragraph.

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## **NEW SECTION 2: GOING CONCERN**

As presented in IAASB's initial proposal, the auditor's report will include a new section containing the auditor's conclusion on the appropriateness of management's use of the going concern basis of accounting. This section will include:

1. An explanation of the going concern basis of accounting in the context of the applicable financial reporting framework;
2. A statement by the auditor as to whether the management's use of the going concern basis of accounting is appropriate when preparing the financial statements;
3. A statement as to whether material uncertainties in relation to going concern have been identified, and
4. A statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern.

While going concern is undoubtedly of interest to the users of financial statements, the inclusion in the auditor's report of a section dedicated to going concern had previously raised concerns that auditors will be expected to assume responsibility for the going concern assessment, or that the auditor's opinion will be taken as a "guarantee" of the entity's financial viability. This may not resonate with stakeholders who believe that management has a bigger role to play in the transparency of an entity's going concern. Currently, there is no requirement in the accounting standards for management to include a statement on the entity's going concern unless material uncertainties have been identified.

IAASB recognises the need for a holistic approach to address going concern in financial reporting and is working with the accounting standard-setters to revise the relevant accounting standards to respond to stakeholders' concerns relating to the adequacy of management's disclosures about going concern and the related effect

on the work effort and reporting by auditors. The finalisation of auditor reporting related to going concern may defer depending on the status of the accounting standards. Notwithstanding these developments, IAASB is seeking feedback on the potential changes on going concern and whether such reporting will be misinterpreted by users.

### NEW SECTION 3: OTHER INFORMATION

The audited financial statements may be accompanied by other information which is not part of the financial statements, but which is relevant to users. While this information does not need to be audited or reviewed, a separate project by IAASB proposes that the auditor does in fact have some responsibilities with respect to such information, and it should therefore be covered in a new section of the auditor's report. Pending finalisation of the separate project by IAASB, this section may include:

1. A description of the auditor's responsibilities with respect to the "other information";
2. A list of the documents that contain the "other information" to which the auditor's responsibilities apply;
3. A statement addressing the outcome of the auditor's work on the "other information", and
4. A statement that the auditor has not audited or reviewed the "other information" and therefore does not express an audit opinion or review conclusion on it.

### TRANSPARENCY AND EASE OF USE

To make the auditor's report more reader-friendly, the ED contains guidance on how the report's content should be organised. Specific headings are required for the various sections to make them more easily identifiable, and it is recommended that certain information, such as the auditor's opinion and entity-specific information, should be prominently placed. The ordering of information is



not mandatory. However, a preferred ordering of the report's content, as illustrated in the examples provided in the ED, would be as follows:

1. Opinion
2. Basis for Opinion
3. Key Audit Matters
4. Going Concern
5. Other Information
6. Responsibilities of Management and Those Charged with Governance

7. Auditor's Responsibilities for the Audit of the Financial Statements
8. Report on Other Legal and Regulatory Requirements

The *Basis for Opinion* section will also contain an explicit statement on auditor independence and compliance with other relevant ethical requirements. For greater transparency,

The IAASB project to change auditor reporting is a key international development which has far-reaching implications on a worldwide basis. As a financial hub, Singapore should prepare well and embrace the changes. Contrary to common belief, the changes to auditor reporting would not only impact the auditors but also the companies. The Institute of Singapore Chartered Accountants (ISCA) believes that the changes will enhance corporate governance and increase market confidence because of the increase in informational value in auditor reporting. ISCA will be hosting a Forum titled *The Future of Auditor Reporting - Shaping Communication and What It Means For You* on 23 October 2013. Do join us at this Forum which will help prepare the business community and the auditing profession for the latest updates on this front.





this statement should also include disclosure of the source of the applicable ethical requirements.

For increased transparency, the ED proposes an improved description of the auditor's responsibilities and the key features of the audit. This description should help to correct misconceptions among users as to the auditor's role.

Finally, IAASB has proposed in the ED to disclose the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant security threat to the partner. This disclosure is only required for audits of financial statements of listed companies.

### **A CHANGE FOR THE BETTER**

The proposed ISAs, particularly with regard to the *Key Audit Matters* section, represent an important development in global auditor communication. Notwithstanding some of the concerns raised or potential challenges that may be faced by the audit profession, there is a strong case for this major transformation of content and structure of the auditor's report. Firstly, the new disclosures would no doubt add more colour and insights to the current binary report, shedding more light on critical entity-specific

audit matters which would be of interest to users. Matters which are currently only communicated between auditors and those charged with governance are now brought to the table and presented in a public report.

Secondly, the requirements for more disclosures result in renewed focus of the auditor on the key matters to be reported, which may help to increase professional skepticism and thereby improve audit quality. Providing greater transparency about the audit also improves the perception and visibility of audit quality, perhaps "repairing" the damage done to the audit profession in light of the corporate scandals, and increasing the confidence that users have in the audit and the financial statements.

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These changes may also bring about an improvement in the quality of financial reporting. Key audit matters are required to make reference to the corresponding management's disclosure in the financial statements to enable users to understand both management's and auditor's perspectives on those matters raised. This would no doubt result in greater focus on

high quality disclosures as management would now be more mindful of their assumptions used, figures presented and related disclosures. The enhanced auditor's report will also lead to a more robust dialogue between auditors, management and those charged with governance, particularly on the key audit matters that will be communicated. ISCA

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