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NEW AND REVISED AUDITOR REPORTING STANDARDS

# NEW AND REVISED AUDITOR REPORTING STANDARDS

Enhancing Communicative Value



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reporting and improved auditor communications.” ~International Auditing and Assurance Standards Board (IAASB).

On 15 January 2015, IAASB released the New and Revised Auditor Reporting Standards, effective for audits of financial statements for periods ending on or after 15 December 2016; early adoption is permitted. These new and revised Standards, seen as a first step towards enhanced reporting, are expected to have a profound impact on the accounting sector and corporate governance in the years to come.

**BACKGROUND**

The world, and indeed the requirements of the accounting standards, has become more complicated over time, leaving some stakeholders and shareholders out of their depths when it comes to analysing financial statements. The 2008 global financial crisis heightened the scrutiny on corporate governance practices and fuelled further impetus to gain greater insights into the audited financial statements of listed companies and other public interest entities.

The auditor’s report is the auditor’s primary means of communication with an entity’s stakeholders, and as such, it has to be meaningful and be of value for them. The current auditor’s report is often perceived by the users of the financial statements as not providing meaningful insights or information of value. Despite changes to the nature of business and corporate governance



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best practices, the auditor's report has not changed for decades and, for most companies, a standard format is used, with no noticeable difference over time.

Change was essential and, as a result, IAASB started looking at enhancing auditor reporting back in May 2011 with the release of a Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, to consult on the topic of auditor communications as a "call for action".

In June 2012, IAASB unanimously approved the consultation document entitled *Invitation to Comment: Improving the Auditor's Report* (ITC). ITC set out IAASB's indicative direction proposed for the future auditor's report. The ultimate objective of this project was to appropriately enhance the communicative value and relevance of the auditor's report.

The Exposure Draft (ED), *Reporting on Audit Financial Statements: Proposed New and Revised International Standards on Auditing* (ISAs), was released on 25 July 2013 and the comments received were discussed in March 2014.

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~International Auditing and Assurance Standards Board





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### IN WITH THE NEW

Users of financial statements have long called for deeper insights and greater transparency as to the key matters that are discussed by the auditors with those charged with governance (TCWG), that is, the Board and the Audit Committee (AC). These discussions are mandated by auditing standards and as such, users wanted to be privy to these discussions and their outcomes.

Of particular focus are the areas of significant auditor attention in performing the audit. These are the areas that are communicated to TCWG at the planning meeting at the outset of the audit, where the scope of the audit engagement is discussed and agreed on. These can also be areas which, while not initially planned for, become areas of significance during the performance of the audit. The auditor's conclusions regarding these areas

are presented to TCWG at the end of the audit. Often, these areas relate to significant management judgement areas in the preparation of the financial statements, and significant judgements made by the auditor in forming an opinion on the financial statements as a whole. The key enhancements to the auditor's report lie mainly in the following areas:

- + For audits of financial statements of listed entities:
  1. Key Audit Matters
  2. Disclosure of the name of the engagement partner
  
- + For all audits:
  3. Opinion section required to be presented first, followed by a Basis of Opinion section
  4. Enhanced auditor reporting on Going Concern
  5. Affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities
  6. Enhanced description of the responsibilities of management and the auditor

As a result, the new and revised standards are:

- + **ISA 700 (Revised)**  
Forming an Opinion and Reporting on Financial Statements
- + **ISA 701 (New)**  
Communicating Key Audit Matters in the Independent Auditor's Report
- + **ISA 705 (Revised)**  
Modifications to the Opinion in the Independent Auditor's Report
- + **ISA 706 (Revised)**  
Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
- + **ISA 260 (Revised)**  
Communication with Those Charged with Governance
- + **ISA 570 (Revised)**  
Going Concern



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## A NEW PERSPECTIVE

While all the Standards and enhancements have their own value, undoubtedly, the new report section communicating on key audit matters (KAM) is expected to be the most impactful and insightful. This will be applicable to all listed entities.

KAM are those matters that, in the auditor's judgement, are of most significance in the audit of the current-period financial statements. IAASB acknowledged the importance of achieving an appropriate balance between the need for prescription in the standard to promote consistency in which matters are determined and communicated as KAM, and the need to allow for auditor judgement to ensure that KAM communicated in the auditor's report are as entity-specific and relevant as possible.

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**Studies show that the most valuable aspect of the enhanced reports is the discussion of risks; the studies also show that stakeholders recognise that enhanced reports represent a good start, and welcome more insightful reporting.**

Accordingly, a decision framework was devised for auditors using their currently-required communications with TCWG as a starting point. From the matters communicated to TCWG, the auditor determines those matters that required significant auditor attention. In fulfilling this requirement, the auditor is required to explicitly consider:

- ✦ The areas of higher assessed risks of material misstatement, or "significant risks" identified in accordance with the International Standards on Auditing;
- ✦ Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty;
- ✦ The effect on the audit of significant events or transactions that occurred during the year.

KAM that are to be reported in the auditor's report are expected to cover a description of KAM and how the matter was addressed in the audit.

While these New and Revised Auditor Reporting Standards are not yet effective, TCWG, specifically members of the AC, and external auditors should start having discussions now as to what KAM are expected to be included in the auditor's report and align those KAM to those areas of risks reported by the auditors in their report to the AC on conclusion of their audit. Key implementation issues include how long or how short the narrative should be, as well as how "layman" or technical it should be to be understandable yet professional, and not lose the importance of the key message that the auditor is trying to convey.

Further, IAASB goes on to say that care may be necessary so that the language used in the KAM description:

- ✦ Relates the matter directly to the specific circumstances of the entity, while avoiding generic or standardised language;
- ✦ Does not imply that the matter has not been appropriately resolved by the auditor in forming the opinion;
- ✦ Takes into account how the matter is addressed in the related disclosure(s) in the financial statements, if any;
- ✦ Does not contain or imply discrete opinions on separate elements of the financial statements (piecemeal option).

Brevity and materiality are pivotal when reporting KAM. Auditors should be concise and laser-focused. The language used should be easy to understand for the users. Auditors should exercise professional scepticism and refrain from "watering down" their reports or resorting to generic boilerplate or template reporting which would negate the value of the new audit reporting. Care would need to be taken and adequate time spent on the description of KAM by senior members of the audit team as it is observed that to write something that is succinct and yet communicate the essence of the matter can be challenging and painstaking. As Mark Twain famously said, "I didn't have time to write a short letter, so I wrote a long one instead."

As we all would appreciate, more time will be spent on clear communications of KAM, ensuring that they satisfy the auditor's responsibilities under the auditing standards, as well as on the responsibilities of TCWG regarding matters of sensitivity. Time will also need to be spent by senior management and TCWG to ascertain that KAM reflect the facts and circumstances relating to matters most significant to the audit and auditors.



**The changes made to the auditing standards bring increased transparency and enhanced informational value to the users of the financial statements. They also serve to enhance communications between the auditor and the users of financial statements, as well as between auditors and TCWG.**

## RAISING THE FLAG

According to IAASB, investors and others have often requested for an early warning of potential issues that may exist with respect to an entity's ability to continue as a going concern, and in particular in a "close call" situation.

doubt on the entity's ability to continue as a going concern, but after considering management's plans to deal with these events or conditions, management and the auditor conclude that no material uncertainty exists.

In the past, issues relating to going concern, specifically,

These are situations where events or conditions were identified that may cast significant

communications and disclosures, were primarily left to management and TCWG as that is where the responsibility lies. International Accounting Standard (IAS) 1 *Presentation of Financial Statements* requires management to make an assessment of the entity's ability to continue as a going concern when preparing financial statements.

IAASB believes that there is a role here for auditors to play, in considering the adequacy of





disclosures relating to going concern.

There is now a new requirement for auditors to evaluate the adequacy of these going concern disclosures in “close call” situations with guidance to support this evaluation. The auditor’s report will have a new section specifically on going concern, where the auditor will draw the user’s attention to the disclosures around the existence of material uncertainty related to going concern.

The new separate section in the

auditor’s report, with the header “Material Uncertainty Related to Going Concern”, is intended to highlight the existence of any materiality uncertainties. It will include either one of the following:

- ➔ If the disclosures are adequate, draw attention to those disclosures, or
- ➔ If the disclosures are inadequate, a modified opinion will be included in the first section of the auditor’s report.

Management’s responsibility on going concern will be reiterated in the auditor’s report together with the auditor’s responsibility to conclude on the appropriateness of management’s use of the going concern basis of accounting, and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern.



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## OTHER ENHANCEMENTS

Other than the key enhancements to the auditor's report around KAM and Going Concern, there were other key enhancements to the auditor's report arising from this project:

- **Independence and ethical responsibilities**

The auditor's report will include an affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities, with disclosure of the jurisdiction of origin of those requirements or reference to the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants;

- **Auditor's responsibilities**

Certain components of the enhanced description of the responsibilities of the auditor, as discussed earlier, together with the key features of an audit that are included in the "Auditor's Responsibility" section, can be presented in the main body of the auditor's report or a separate appendix to the report;

- **Name of partner**

Disclosure of the name of the engagement partner.

## WHAT NEXT?

In the United Kingdom, elements of enhanced reporting have already been effective for listed companies for a couple of years now, and various studies, more notably the Citi Research report on the *New UK Audit Reports* in March 2014, have been undertaken to measure the effect of these changes and how continuous improvement can better meet the objective of enhancing these standards. However, one thing is clear – investor reactions have generally been positive. Studies show that the most valuable aspect of the enhanced reports is the discussion of risks; the studies also show that stakeholders recognise that enhanced reports represent a good start, and welcome more insightful reporting.



