

Refreshed Auditor's Report: Assessing the impact

January 2018



Overview

The overall objective of having an independent auditor and conducting an audit in accordance with standards on auditing is to enhance the confidence of the intended users in the financial statements. The auditor's report, wherein the auditor expresses an opinion on the financial statements, was meant to assist in this process. However, the existing templatised reporting language and lack of useful information for stakeholders in the auditor's report are some of the challenges faced by the auditors.



The international scenario

The International Auditing and Assurance Standards Board (IAASB) has acknowledged that enhanced auditor reporting is critical to influencing the value of the financial statement audit and to the continued relevance of the audit profession. Therefore, the IAASB issued a set of new and another set of revised auditor reporting standards in January 2015, which are aimed at enhancing the communicative value and relevance of the auditor's report. The board also modified the design of the report to accommodate evolving national financial reporting regimes while ensuring that common and essential content is being communicated. These standards are effective for audits of financial statements for periods ending on or after 15 December 2016.

In India, the new auditor's reporting standards will be effective for audits of all financial statements for the period beginning on or after 1 April 2018.

- What are these changes?
- How do they affect you?
- What are the benefits and potential challenges?

This newsletter gives a snapshot of the new reporting standards and their potential implication.



Requirements in India

The standards on auditing in India, which now find their place in the Companies Act, 2013, are largely consistent with the international standards. The Institute of Chartered Accountants of India (ICAI) has made corresponding changes and issued the new and revised standards on the same lines as the IAASB. While these standards were originally slated to be effective for audits of financial statements for periods beginning on or after 1 April 2017, the date was later deferred by a year. Now, these are applicable for audits of financial statements for periods beginning on or after 1 April 2018.

The publication aims to provide readers a brief snapshot of the changes they can expect to see in the 2019 annual auditor's report.

What has changed?

The new auditor's report is a significant shift from the 'templatised' model under the existing standards which leads to almost identical reports with no additional observations from the auditors. Some of the changes in the report include:

- Inclusion of key audit matters (KAMs) that are selected from matters communicated with those charged with governance, in case of listed entities.
- Reordering of the contents of the auditor's report, with the audit opinion finding its place right at the beginning of the report.
- Revised description of management's responsibilities, which now includes a requirement to explain the assessment of going concern assumption; and
- Revised description of auditor's responsibilities, which now includes an assertion relating to independence of the auditor.

Paradigm shift in the way the auditor's report:

- **Looks** – New structure of the report; and
- **What it contains** – The new requirement to include key audit matters



Summary of changes in the standards*

SA 700 (Revised), Forming an Opinion and Reporting on Financial Statements: Overarching revision to establish the new reporting requirements including the new structure of auditor's report.

SA 701, Communicating Key Audit Matters in the Independent Auditor's Report: New standard which deals with the auditor's responsibility to communicate KAMs in the auditor's report. It is intended to address both, the auditor's judgement as to what to communicate in the auditor's report and the form and content of such communication.

SA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report: Revised to clarify the impact of the new reporting requirements while expressing a modified opinion.

SA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report: Revised to explain the relationship between the emphasis of matter and other matter paragraphs and the KAMs.

* Conforming revisions have already been made to Standard on Auditing (SA) 260 (Revised), **Communication with Those Charged with Governance**, and SA 570 (Revised), **Going Concern**, which are effective for audits of financial statements for periods beginning on or after 1 April 2017. The Auditing and Assurance Standards Board (AASB) of the ICAI has also issued SA 720, **Auditor's Responsibilities Relating to Other Information**, which has undergone changes as a result of the new and revised reporting standards.

The new and revised auditor's reporting standards are expected to:

Enhance transparency to facilitate users of financial statements in understanding significant judgements made by the auditor in forming opinion on the financial statements, since they are directly related to areas of significant management judgement in preparing the financial statements.

Increase robust communication between those charged with governance, management and the auditor, especially on the KAMs.

Increase attention of management and those charged with governance to the disclosures in the financial statements referred to in the auditor's report.

Auditor's Report : Before and After

Audit Report (SA 700)

Old Format of Audit Report (applicable till 31 March 2018)	New Format of Audit Report (applicable from 1 April 2018)
 Title and addressee	 Title and addressee
 Introductory paragraph	 Auditor's Opinion
 Management responsibility	 Basis for Opinion
 Auditor's responsibility	 Emphasis of matter and/or other matter paragraph(s)
 Basis for opinion	 Key Audit Matters(KAM) Paragraph (SA 701) (Applicable to listed entities only)
 Auditor's opinion	 Management's responsibilities
 Emphasis of matter and/or other matter paragraphs (SA 706)	 Auditor's Responsibilities for the Audit of the Financial Statements
 Report on other legal and regulatory requirements	 Report on other legal and regulatory requirements
 Signature, date of the report and membership number and place of signature	 Signature, date of the report and membership number and place of signature

What are Key Audit Matters?

Key Audit Matters (KAM) are the ones that, in the auditor’s professional judgement, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance (TCWG).

The new SA 701 observes that professional judgement will be needed to determine which, and how many, key audit matters should be included in the audit report.

Key audit matters are drilled down from the

- Matters communicated with TCWG
- And of the above, the matters that required significant auditor attention

The areas that require significant auditor attention are of higher assessed risks of material misstatement, or identified significant risks, areas that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty or significant events or transactions that occurred during the year.

The description of KAM in the auditor’s report will include a reference to the related disclosure(s), if any, in the financial statements and is expected to address:

- Why** the matter was considered to be one of most significant in the audit and therefore determined to be a KAM? and
- How** the matter was addressed in the audit?

As mentioned earlier, KAM is required to be communicated in the auditor’s report of audits of financial statements of listed entities in accordance with new SA 701. However, KAMs may also be included if:

- **Law or regulation** require KAM for audits of entities other than listed entities.
- Auditors **voluntarily**, or at the request of the management or TCWG, decide to communicate KAM in the auditor’s report for entities other than listed entities.

IAASB and consequently, the AASB have recognised that there may be situations when a KAM cannot be included in the auditor’s report. This could be on account of a law or regulation precluding public disclosure about the matter or in extremely rare circumstances, where 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. However, the second exception, will not apply if the entity has publicly disclosed information about the matter.



How does it impact stakeholders?



Experience till now

Internationally, the new and revised auditor's reporting standards have already been effective in several countries including China, Australia, Singapore, Malaysia and some countries in Europe, among others. The UK was one of the first countries to roll out these requirements. UK's Financial Reporting Council (FRC), in its review of the second year of extended auditor's reports (Extended auditor's reports: A further review of experience - released in January 2016), has received feedback that investors have welcomed extended auditor reporting and greatly value the enhanced information it provides.

The Public Company Accounting Oversight Board (PCAOB) has also adopted a corresponding auditing standard on the same lines, the requirements of which are expected to apply in a phased manner, with the first phase being applicable for audits for fiscal years ending on or after 15 December 2017 (the requirements relating to reporting Critical Audit Matters (CAMs) which correspond to KAM have been deferred).



Our view

We expect that on the lines of the experiences around the world, the new reporting standards will lead to a significant change in the manner and extent of reporting and is expected to get streamlined over a period of time. It is likely that there will be apprehensions, both from the perspective of auditors as well as management in terms of what is eventually covered in the auditor's report and its likely impact. To ensure effective implementation, it is essential that the auditors, management and audit committees begin to understand and assess these requirements at the earliest.

The reports which have earned the greatest praise from investors this year are carefully structured with the end user in mind, and signpost key information. They also include clear, concise and transparent disclosures about risk, scope and materiality, as well as the critical areas where professional judgement and assumptions have been addressed.

- UK FRC (January 2016)

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