A clear view into audit

The introduction of key audit matters to the auditor’s report will enable users to better understand how decisions have been made and lift corporate governance standards.

You toss and turn in bed. Work is very much on your mind. You have just made some tough judgment calls at the office. The decisions could have gone either way but you are convinced you have done the right thing. Still, you wish there was a way to let others know why you did what you did.

If you are an auditor of a listed company, you will have this avenue a little over a year from now, thanks to something called key audit matters (KAMs).

The addition of a section on KAMs in the auditor’s report is roundly regarded as the most innovative and important of the several enhancements arising from the International Auditing and Assurance Standards Board’s (IAASB) new and revised auditor reporting standards issued earlier this year.

These standards are mandatory for listed companies and effective for audits of their financial statements for periods ending on or after 15 December next year. However, early adoption is permitted and other entities can opt to apply these standards.

The changes are designed to make the auditor’s report more insightful, transparent and readable than the meagre current format, which is little else than a pass-or-fail conclusion. ‘The auditor’s report is the key deliverable communicating the results of the audit process,’ explains the IAASB. ‘Investors and other financial statement users have asked for a more informative auditor’s report – in particular for auditors to provide more relevant information to users.’

It adds that the communication of KAMs may also provide users with a basis to further engage with management and those charged with governance.

The board defines KAMs as those matters that, in the auditor’s judgment, were of most significance in the audit of the current-period financial statements. But if you seek a simpler description, consider the one offered by KPMG: the areas that the auditor worried about and focused on the most during the audit. Or take it from PwC, which calls the KAMs section ‘a window into what kept the auditor up at night’.

‘Game changer’

However you look at it, the introduction of the section is set to influence, directly or otherwise, how financial statements are prepared, audited and used. It may even boost corporate governance.

‘This expanded reporting is definitely a game changer for all market participants – that is, the auditors, boards, audit committees, shareholders and regulators,’ says Rita Benoy Bushon, CEO of the Minority Shareholder Watchdog Group (MSWG). ‘It provides for more constructive communication with investors in key areas, thus leading to greater transparency and informed investors.’
The financial reporting chain starts with those who prepare the accounts. The new rules that overhaul the auditor’s report have no authority over this aspect, and yet they are likely to trigger changes in how companies produce financial statements for public consumption.

Many in the accounting sector hope that this will eventually elevate vigilance, discipline and the quality and flow of information within the financial reporting ecosystem. Audit Oversight Board (AOB) executive chairman Nik Mohd Hasyudeen Yusoff notes that, with the inclusion of KAMs in auditor’s reports, preparers and audit committees have to be more careful so as to avoid such information adversely impacting their reputation, even when the financial statements are not qualified or modified.

He also anticipates that the listed companies will now work harder at being consistently timely in releasing accounts. This way, they minimise the chances of being surprised by KAMs that may signify control weaknesses in the financial reporting.

**Disclose and explain**

Another possible response to KAMs is that companies may feel compelled to disclose and explain more in their financial statements, mainly to share their perspectives on issues highlighted by the auditors.

‘This will improve the communicative value of a set of audited financial statements,’ says Lock Peng Kuan, partner and co-leader, audit and assurance, at Baker Tilly Malaysia. ‘Therefore, when preparing the accounts, the ultimate aim is to make a set of audited accounts that can speak for itself.’

There is no doubt that the KAMs section will lead to a marked difference in the planning of audit jobs and the presentation of the findings. At the same time, most industry players do not foresee major changes in the actual performance of the audits.

PwC Malaysia assurance leader Pauline Ho expects her firm’s audit approach to largely remain the same. ‘The issuance of the new and revised auditor reporting standards does not affect existing standards that govern the planning and performance of audits,’ she says. Instead, there will be added emphasis on other elements such as who in the audit team should handle the identification and reporting of KAMs.

Along with this comes the need for sturdier documentation to back up the KAMs and greater engagement with management and those charged with governance. A lot of thought and care must go into this process, and the earlier the better.

‘Shift in focus’

Yap Kim Len, Deloitte Malaysia’s technical director for audit, believes that the requirement for KAMs will modify the manner in which auditors strategise audit execution. ‘It is expected that there will be a shift in the focus. At the onset of the audit, auditors will now need to think more about the final reporting process with respect to communicating KAMs,’ she says.

Most auditors would agree that it is a huge challenge to articulate KAMs without creating wrong impressions and revealing information that the companies deem as sensitive or confidential. And if auditors play safe and churn out boilerplate reports, their credibility and competence may be questioned. Also, weak audit reporting is a disservice to the people who rely on audited financial statements.

Ho points out that investors always want to know the auditor’s independent view. She reckons that there will be increased investor interest in audited accounts once KAMs become a feature of the auditor’s report.
“The investors are keen to hear from the auditors on the key matters arising from the audit, why these are important, how the auditor approaches these matters and their resolution,’ she adds.

Lock has a similar take on how people will find extra value in the new auditor’s report. ‘By reading the KAMs section, one can ride the audit journey with the auditors in understanding a set of financial statements. This is helpful if one needs to understand better the risks embedded in an entity in order to align their investment strategy,’ he explains.

Lift the standard of corporate governance
Meanwhile, Nik Hasyudeen believes that KAMs reporting will help lift the standard of corporate governance over the long term, primarily via the audit committees. This is because the improvements in the auditor’s report’s transparency, relevance and disclosures will drive the committees to fulfil their functions and responsibilities more effectively.

As a result of deeper engagement with the auditors, the committees receive more timely and relevant feedback and information that allows them to better oversee the companies’ internal controls and financial reporting. In addition, shareholders can leverage on the auditor’s commentary on KAMs to engage with company management during AGMs.

Yap agrees that the revamp of the auditor’s report has placed the audit committee in the spotlight. She says the committee is set to play a bigger role in understanding how KAMs are identified and addressed by the auditor. It is the committee’s responsibility, for instance, to sit down with the auditor to go through the potential KAMs.

The committee may also have to explain matters such as the appropriateness of the audit plan, how significant audit issues have been resolved, and whether the audit opinion is supported by sufficient evidence.

‘Therefore, scrutinising the key financial reporting judgments made by management and reporting these to shareholders is one of the most significant tasks of the audit committee,’ she adds.

With the new auditor reporting requirements kicking in little more than a year away, it is strange that companies have not come out to express concerns over the consequences of the KAMs section. Can it be that they see no point in fighting the inevitable? Or are they somehow not fully aware of the changes ahead?

Others have warned about possible problems – such as accounts users struggling to decipher the KAMs sections, auditors sticking to boilerplate language, and higher audit costs – but these do not appear to be deal-breakers.

Lock urges auditors to begin talking to management and boards about the new auditor’s report.

‘Early and continuous engagement with stakeholders is the key for a smooth and meaningful implementation of this new reporting,’ he says.

Errol Oh, executive editor, The Star

Key audit matters: the global picture
The International Auditing and Assurance Standards Board is not alone in wanting the auditor’s report to communicate key audit matters. Several other bodies have introduced similar rules or are planning to do so.

France appears to be a pioneer. Since August 2003, its auditors are legally obliged to provide information that helps audit report users to better understand the reasons behind the auditors’ opinion on the financial statements. The commentary is called justification of assessments.

A February 2011 perception study, commissioned by the French National Institute of Statutory Auditors, came up with this conclusion: ‘Overall, the justification of assessments is considered within the statutory auditors’ professional environment as very useful in principle, but in need of some major improvements in practice.’

In the UK, the Financial Reporting Council came up with new requirements for auditor’s reports for listed companies, with effect for periods commencing on or after 1 October 2012. One main objective of this is to provide greater transparency about the audit.

Among other things, auditors must now describe the most significant risks of material misstatement and how these were addressed. The section in the auditor’s report that covers this is usually called ‘discussion of risks’ or ‘areas of audit focus’.

After reviewing the first-year experience with the extended auditor’s reports, the council said it was encouraged by the auditors’ innovation and diverse approaches in meeting the new requirements.

‘In the main, investors have warmly welcomed the overall response by auditors to the extended auditor’s report requirements, but with some cautionary notes,’ it adds in a March 2015 publication.

With new legislation coming into effect in the middle of next year, audit opinion on the accounts of public interest entities in the European Union must be supported with a description of the most significant assessed risks of material misstatement, a summary of the auditor’s response to those risks and, where relevant, key observations relating to those risks.

Meanwhile, in August 2013, the US-based Public Company Accounting Oversight Board proposed a number of changes to the auditor’s report, including a new section on critical audit matters, a parallel of key audit matters.