A new foundation in auditor’s reporting

In January 2015, the International Auditing and Assurance Standards Board (IAASB) issued its new and revised Auditor Reporting Standards, which require auditors to provide more transparent and informative reports on the companies they audit. These standards have been issued in response to demand from users of financial statements, in the wake of the financial crisis, for more relevant information on audits.

The aim of the standards is to provide auditor’s reports that increase the public’s confidence in both the audit process itself and the financial statements of companies. The IAASB also believes that enhancing auditor reporting will improve communications between the auditor and investors, as well as between auditors and those charged with governance.

The new and revised Auditor Reporting Standards are effective for audits of financial statements for periods ending on or after 15 December 2016.

On 31 August 2015, the Hong Kong Institute of Certified Public Accountants (HKICPA) released the new and revised auditor reporting standards. These standards are based on the international standards (ISAs) and have the same effective date.

On 8 January 2016, the Chinese Institute of Certified Public Accountants (CICPA) issued exposure drafts for its new and revised auditor reporting standards to cope with this new reporting regime.

These new standards are expected to reinvigorate the audit and change the manner in which auditors communicate their work in the auditor’s report. This will inevitably impact other stakeholder groups, including the preparers of the financial statements (CFOs and their finance team), the directors, the investors and the regulators.

Since the new standards apply (in many jurisdictions) to the audits of the financial statements towards the end of 2016, management, those charged with governance and auditors must start preparing for their implementation now.
**Key Audit Matters**

One of the challenges with the financial statements is that they are fairly complicated. As a result, the audit is also quite complex and requires the auditor’s assessment of risks of material misstatement to those financial statements to drive the performance of the audit.

In today’s “boilerplate” auditor’s report, it is not possible for financial statements users to understand where the greatest of those risks lie in the eyes of the auditor.

For this reason, a particular area of focus within the new standards is the requirements as set out in the new ISA 701 Communicating Key Audit Matters in the Independent Auditor’s Report.

For audits of listed entities, a new section in the auditor’s report called Key Audit Matters (KAM) will highlight those matters that, in the auditor’s professional judgment, were of most significance in the audit.

KAM are included in a separate section of the auditor’s report explaining the nature and intent of KAM.

However, KAM is not:

- A substitute for disclosures in the financial statements
- A substitute for the auditor to express a modified opinion
- A substitute for reporting any matters relating to going concern or
- A separate opinion on an individual matter

From the matters that required the auditor’s significant attention, the auditor determines which were of the most significance in the audit of the current period. These matters are KAM.

In most cases, KAM relate to significant complex matters disclosed in the financial statements, e.g., valuation of goodwill and other long-term assets, valuation of financial instruments, difficult or unique aspects of revenue recognition, or accounting for significant acquisitions.

The description of a KAM should be clear, concise, understandable and entity-specific.

**KAM describes**

“Why the matter was determined to be a KAM; How it was addressed in the audit; and Reference to disclosure(s) in the financial statements”
KAM: Matters of most significance in the audit

Matters communicated with TCWG

Matters requiring significant auditor attention

KAM: Matters of most significance in the audit

Is a KAM a form of qualification?
Stakeholders are used to the binary “pass/fail” opinion. With KAM reporting, the stakeholders might perceive it as a piecemeal qualification on matters determined to be KAMs. The description of auditor’s procedures contained in the KAM section of the auditor’s report might be misunderstood without proper context.

Other concerns are:
- Will KAMs make the auditor’s report as the primary source of “red flags”, such as going concern?
- How will KAMs be interpreted by stakeholders and the market?
- Would it trigger a negative market response?
- Will stakeholders perceive matters highlighted as KAMs as areas where management and TCWG failed to discharge their responsibilities properly?

One very important message to be conveyed to the stakeholders is that KAMs are not an avenue for the auditor to express qualification on matters highlighted as KAMs. KAMs are addressed in the context of the audit of the financial statements as a whole, and the auditor does not provide a separate opinion on these matters.

Therefore, stakeholder education is critical in addressing the potential consequences of misinterpreting KAMs. The entities, the relevant professional bodies and authorities should actively engage and educate the stakeholders so that they understand the objective of KAMs, and how a matter is determined to be a KAM.

What is KAM?
KAM is defined in the standard as “Those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. KAM are selected from matters communicated with those charged with governance”.

In essence, KAM are drawn from matters that are communicated with those charged with governance (TCWG).

ISA 701 includes a judgment-based decision-making framework to help the auditor decide which issues from the audit would count as KAMs.

The auditor firstly narrows the matters communicated with TCWG to matters that required significant auditor attention. In doing so, auditors will explicitly consider:

- Areas of higher risk of financial statements material misstatement
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, 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 period

The fact that these considerations are required does **not** imply that matters related to them are always KAM.

KAM Decision-making framework

Always consider:
- Higher assessed risks on financial statements misstatement
- Areas of significant management judgment and estimation uncertainty
- Significant transactions or events

Description of each KAM in the auditor’s report is required to include:
- Why the matter was considered to be one of most significance in the audit
- How the matter was addressed in the audit
- Reference to the related disclosure(s)
The changing audit reporting landscape

Many jurisdictions that use the ISAs have already issued exposure drafts or new auditing standards to implement these new requirements. Some jurisdictions may extend the applicability of certain requirements in the ISAs for audits of listed entities to audits of other entities, such as public interest entities. As a result, additional jurisdiction-specific guidance may be issued to further address auditor reporting requirements.

Regulators and standard-setters in several jurisdictions have also undertaken auditor reporting initiatives, including the UK, the Netherlands, the US, and the European Union. For instance, the UK measures were effective for audits for periods commencing on or after 1 October 2012 while the Netherlands issued a standard in late December 2014 that applies to periods ended on or after 15 December 2014.

Recently, the UK Financial Reporting Council (FRC) conducted a post-implementation review. In a survey of more than 150 auditor’s reports, it was found that the top five KAMs most reported in the UK were:

- Impairment of assets
- Tax
- Goodwill impairment
- Management override of controls and
- Fraud in revenue recognition

Other changes

In addition to the KAM, some of the other changes introduced to the auditor’s report are:

- Prominent placement of the auditor’s opinion towards the beginning of the auditor’s report
- New descriptions of responsibilities relating to going concern to be included in the respective sections for management’s and auditor’s responsibilities
- Enhanced reporting requirements when a material uncertainty related to going concern exists
- Identification of TCGW within the management’s responsibilities section who is responsible for the oversight of the financial reporting process (in many cases, the Audit Committee)
- Revised auditor’s reporting on other information applicable for entities issuing annual reports, considering whether there is a material inconsistency between other information and the auditor’s knowledge obtained in the audit
- New requirement to state, at the date of the auditor’s report, other information in the annual report of the listed entity the auditor has obtained or expects to obtain

An illustration of the revised auditor’s report that highlights the key changes introduced to the auditor’s report is included on pages 5-7.

What’s next?

Significant efforts will be required to implement the enhanced auditor’s reporting. Management, TCWG and the auditors should align their goal of improving communications now so as to ensure smooth implementation in 2016 calendar-year audits.

The introduction of KAM is a significant enhancement that will change not only the auditor’s report, but more broadly the quality of financial reporting by providing more informative value to investors and other key stakeholders.

That said, it is important to emphasise here that it remains the responsibility of management, with the oversight of TCWG, to communicate relevant information to users about the entity and its financial performance, including providing adequate disclosures in accordance with the applicable financial reporting framework.
INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20x1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statement present fairly, in all material respects, (or give a true and fair view of) the consolidated financial position of the Group as at December 31, 20x1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the international Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code), and we have fulfilled our other ethical responsibilities in accordance with the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

(For listed entities) Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each KAM in accordance with ISA 701 Communicating Key Audit Matters in the Independent Auditor’s Report]

Other information [or other appropriate title]

Management is responsible for the other information. The other information comprises the [information included in the Annual Report, but does not include the financial statements and our auditor’s report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

Enhancements to the Auditor’s Report

Opinion first. The auditor’s opinion—the “pass/fail” statement that users have said they continue to value—is required to be positioned at the beginning of the report, followed by the Basis for Opinion.

Basis for Opinion section is required. Currently only required when the auditor’s opinion was modified.

New affirmative statement about the auditor’s fulfillment of independence and other relevant ethical responsibilities requirements.

The new KAM section is the centerpiece of the revised auditor’s report.

A separate section relating to other information is required under the revised ISA720 The Auditor’s responsibilities Relating to Other Information
In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. [We have nothing to report in this regard [or a statement that describes any material misstatement of the other information]].

**Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error. In preparing the consolidated financial statements, management is responsible for assessing the Group’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group’s financial reporting process.

**Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements**

Our Objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

(Because of the increased length of this section, ISA 700 includes a provision that certain components of the following description in the auditors’ responsibilities section may be presented in an appendix to the auditor’s report or, where law, regulation or national auditing standards expressly permit, by reference to a website of an appropriate authority.)

[As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

.../continued

**Enhancements to the Auditor’s Report**

New descriptions of management’s responsibilities relating to going concern. Intended to reflect the requirements of the applicable financial reporting framework.

Identification of TCWG is required when a separate body exists that is responsible for the oversight of the financial reporting process (in many cases, the audit committee). When individuals responsible for such oversight are also responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Expanded description of the auditor’s responsibilities, including key features of the audit. The auditor’s responsibility section is intended to explain more fully the concept of a risk-based audit, as well as to clarify the meaning of certain audit-technical terms. This approach results in a more lengthy description of the auditor’s responsibilities in relation to specific matters, including fraud; internal control, accounting policies and estimates, evaluation the overall presentation, structure and content of the financial statements and disclosures, group audits, and communications with TCWG.
► Obtain an understanding of internal control relevant to the audit in order to
design audit procedures that are appropriate in the circumstances, but not for
the purpose of expressing an opinion on the effectiveness of the Group’s internal
control.
► Evaluate the appropriateness of accounting policies used and the reasonableness
of accounting estimates and related disclosures made by management.
► 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 Group’s ability to continue as a going concern. If we conclude that a
material uncertainty exists, we are required to draw attention in our auditor’s
report to the related disclosures in the consolidated financial statements or, if
such disclosures are inadequate, to modify our opinion. Our conclusions are
based on the audit evidence obtained up to the date of our auditor’s report.
However, future events or conditions may cause the Group to cease to continue
as a going concern.
► Evaluate the overall presentation, structure and content of the consolidated
financial statements, including the disclosures, and whether the consolidated
financial statements represent the underlying transactions and events in a
manner that achieves fair presentation.
► Obtain sufficient appropriate audit evidence regarding the financial information
of the entities or business activities within the Group to express an opinion on the
consolidated financial statements. We are responsible for the direction,
supervision and performance of the group audit. We remain solely responsible for
our audit opinion.

We communicate with those charged with governance regarding, among other
matters, the planned scope and timing of the audit and significant audit findings,
including any significant deficiencies in internal control that we identify during our
audit.

(For listed entities) We also provide [those charged with governance] with a
statement that we have complied with relevant ethical requirements regarding
independence, and to communicate with them all relationships and other matters
that may reasonably be thought to bear on our independence, and where applicable,
related safeguards.

(For listed entities) From the matters communicated with [those charged with
governance], we determine those matters that were of most significance in the audit
of the financial statements of the current period and are therefore the key audit
matters. We describe these matters in our auditor’s report unless law or regulation
precludes public disclosure about the matter or when, in extremely rare
circumstances, we determine that a matter should not be communicated in our
report because the adverse consequences of doing so would reasonably be expected
to outweigh the public interest benefits of such communication.]

Report on Other Legal and Regulatory Requirements
[The form and content of this section of the auditor’s report would vary depending on
the nature of the auditor’s other reporting responsibilities prescribed by local law or
regulation.]

The engagement partner on the audit resulting in this independent auditor’s report is
[name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as
appropriate for the particular jurisdiction]
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