

Auditor Reporting on Audited Financial Statements: The Auditor's Report of the Future



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Agenda

- ▶ Why change?
- ▶ What is changing in the ISAs?
- ▶ What are the key practice risks?
- ▶ Audit Committee Dialogue/Those Charged with Governance



New and Revised Reporting

A large construction crane is silhouetted against a dramatic sky filled with clouds. The sun is low on the horizon, creating a strong backlight effect that illuminates the edges of the clouds and the crane's structure. The crane's long jib extends diagonally across the frame from the bottom right towards the top left. A yellow arrow-shaped graphic points from the left towards the crane, containing the text "Why change?".

Why change?

Why Change?

Short history of recent auditor reporting reform initiatives

- ▶ 2006-2009: IAASB/AICPA joint initiative to explore user perceptions of the usefulness of the auditor's report
 - ▶ European regulators were dissatisfied with the ISAs on auditor reporting – holding out on adopting the clarified suite of ISAs issued in 2009 for use in Europe
- ▶ May 2011 IAASB consultation paper issued seeking to determine whether there are common views among users of audited financial statements and other stakeholders about the usefulness of auditor reporting
 - ▶ Feedback: overwhelming response from global investors that auditor reports need to be more informative about the audit performed.
 - ▶ Users value the “pass/fail” opinion but some, in particular investor advocate groups, want more relevant and decision-useful information about the entity, the financial statements and the audit
- ▶ Concurrently, in the GFC fallout regulators in the N.American, UK & European markets raised challenges about relevance of the audit function
 - ▶ Esp. in systems promoting global financial stability; whether basis for trust in the audit profession is sufficiently robust

Why Change?

- ▶ Following the IAASB initiative, other initiatives to review the current auditor's report and auditor reporting model were commenced in:
 - ▶ Europe: European Commission (EC)
 - ▶ US: Public Company Accounting Oversight Board (PCAOB)
 - ▶ UK: Financial Reporting Council (FRC)

The race was on!

- ▶ Global investor advocacy/representative groups have enthusiastically spurred these developments.
- ▶ **By June 2013, IAASB had issued its ED for proposed revised ISAs for auditor reporting**
- ▶ **In September 2014, IAASB approved new and revised auditor reporting ISAs (and consequential amendments to other ISAs)**

2009 (COMMENCEMENT) —————→ **2013 (EDs)** —————→ **2014 (IAASB final, PLOB approval 12/14)**



What is changing?

What changes in the Reporting ISAs?

- ▶ **ISA 700 – Forming an Opinion and Reporting on Financial Statements**
 - ▶ Scope of the ISA: sets new direction for auditor reporting
 - ▶ New requirements for and content of the auditor's report – all entities
 - ▶ New requirements for auditor reports -- audits of listed entities: disclosure of Key Audit Matters in the auditor's report; disclosure of the name of the engagement partner
- ▶ **ISA 701 – Communicating Key Audit Matters (KAM) in the Independent Auditor's Report**
 - ▶ All new reporting standard (applies only to auditor reporting for audits of listed entities)
- ▶ **ISA 705 – Modifications to the Opinion in the Independent Auditor's Report**
 - ▶ Listed entities: matters that trigger modifications do not require KAM disclosure
 - ▶ Modified reports may include KAM disclosures for other matters (except prohibited for disclaimers)
- ▶ **ISA 706 – Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report**
 - ▶ In general: unqualified/qualified auditors reports may also include EoM/OM paragraphs
 - ▶ Listed entities: no EoM paragraph for matters disclosed as KAM

What will change in other ISAs?

▶ ISA 260 – Communication with Those Charged with Governance

- ▶ New requirement: communicate circumstances that affect the form and content of the AR (if any)
- ▶ New application guidance: communications about significant risks identified by the auditor and significant findings from the audit – i.e. these are relevant to auditor's determination of key audit matters for the auditor's report

▶ ISA 570 – Going Concern

- ▶ Additional requirement: if indicators of going concern uncertainty are identified but auditor concludes there is no material uncertainty about entity's ability to continue as a going concern, to evaluate adequacy of management's disclosure of those matters in the financial statements
- ▶ New requirement for the "EoM paragraph" *Material Uncertainty Related to Going Concern* in an unmodified opinion, if a material uncertainty exists and has been properly disclosed, to be under the heading "Material Uncertainty Related to Going Concern"
- ▶ New requirement to communicate with tcwg on implications for the auditor's report when there are indicators of going concern uncertainty

ISA 700

Most significant changes

- ▶ **Scope of the ISA:** expressly references the need to increase value of auditor reporting by making the information provided in the auditor's report more relevant to users
- ▶ **New requirements – audits of all entities**
 - ▶ Use the required ordering of the sections of the auditor's report – the opinion and basis for opinion paragraphs are required to be positioned first in the report
 - ▶ Basis for opinion paragraph: must include a statement that the auditor is independent of the entity and has fulfilled other ethical responsibilities in accordance with the relevant ethical requirements
 - ▶ Expanded description of management's responsibilities & identify who is responsible for oversight of the financial reporting process. Include management's responsibility for assessing entity's ability to continue as a going concern and whether use of the GC basis of accounting is appropriate; and (if applicable) to disclose matters relating to going concern.
 - ▶ Description of auditor's responsibilities: amended wording to explain meaning of reasonable assurance for users; this section is now required to be in any of three alternative locations
- ▶ **New requirements – audits of listed entities**
 - ▶ Report must communicate Key Audit Matters in accordance with ISA 701; also disclose name of the engagement partner in the report

ISA 700

Form and content of the unmodified auditor's report

- ▶ Title
- ▶ Addressee
- ▶ **Report on the Audit of the Financial Statements**
 - ▶ Opinion
 - ▶ Basis for Opinion
 - ▶ Key Audit Matters *[listed entities only/voluntary disclosure]*
 - ▶ Other information – ISA 720
 - ▶ Responsibilities of Management and Those Charged with Governance for the Financial Statements
 - ▶ Auditor's Responsibilities for the Audit of the Financial Statements *[may be located in an appendix to the auditor's report/may be included by reference to the description contained on another party's website]*
- ▶ **Report on Other Legal and Regulatory Requirements**
- ▶ Name of Engagement Partner
- ▶ Signature / address / date

ISA 700

Form and content of the auditor's report – reporting under ISAs 570/706

► **Report on the Audit of the Financial Statements**

- **Opinion**
- **Basis for Opinion**
- *Emphasis of Matter*
[if an EoM paragraph is needed; for listed entities: EoM may not be used for KAM]
- *Material Uncertainty Related to Going Concern*
[i.e. material uncertainty exists that is properly disclosed]
- **Key Audit Matters** *[listed entities only/voluntary disclosure]*
- *Other Matter* *[if need for an OM paragraph]*
- **Other information – ISA 720**
- **Responsibilities of Management and Those Charged with Governance for the Financial Statements**
- **Auditor's Responsibilities for the Audit of the Financial Statements** *[may be in an appendix to the auditor's report/included by reference to the description on a website of an appropriate authority].*

ISA 701

Communicating key audit matters in the auditor's report

Auditor's objectives are:

- To determine key audit matters (KAM); and
- Having formed the audit opinion on the financial statements, communicate those matters by describing them in the auditor's report

KAM Definition:

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 (TCWG).

Matters that are KAM by nature, but are treated under other ISAs are:

- Material uncertainty relating to going concern, under ISA 570 (Revised), with adequate disclosure in the FS; and
- A matter giving risk to a modified audit opinion in accordance with ISA 705 (Revised)

ISA 701

Determining Key Audit Matters

1. Determine, *from the matters communicated with TCWG*, those matters that required *significant auditor attention* in performing the audit.

Take into account:

- ▶ Areas of higher **assessed risk of material misstatement**, or significant risks identified in accordance with ISA 315;
- ▶ **Significant auditor judgments** relating to areas in the FS that involved significant management judgments, 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.

2. Determine which of the matters determined above were *of the most significance in the audit of the FS of the current period*, and therefore are KAM

ISA 701

Determining Key Audit Matters (cntd.)

ISA 260 – Matters required to be communicated to TCWG

Planned Scope and Timing of the Audit

Overview of the planned scope and timing of the audit, incl. communicating about **the significant risks identified by the auditor.**

May include:

- How the auditor plans to address:
 - (i) the significant risks of material misstatement whether due to fraud or error;
 - (ii) areas of higher assessed risk of material misstatement;
- **The auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters (in relation to auditor reporting performed for a listed entity)**

Significant Findings from the Audit

- Views about **significant qualitative aspects of the entity's accounting practices**, including accounting policies, accounting estimates and financial statement disclosures.
- When applicable, why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;
- Significant difficulties, if any, encountered during the audit;
- Significant matters arising during the audit that were discussed, or subject to correspondence, with management;
- Written representations being requested;
- **Circumstances that affect the form and content of the auditor's report, if any; and**
- Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

Determine those **matters that required significant auditor attention**, esp. areas of

- Areas of higher risk of material misstatement, and where significant auditor judgment was applied for FS items that involved significant management judgement (i.e. significant accounting estimates)
- Effect of significant events or transactions that occurred during the period

Key Audit Matters to Disclose in the AR:

- 1. Select from those matters that required significant auditor attention in performing the audit (above)**
- 2. Those of most significance in the audit of the FS of the current period**

ISA 701

Communicating Key Audit Matters

- In **separate section** of the auditor's report titled "Key audit matters"
- Prescribed **introductory language** in this paragraph stating what KAM are and stating that these matters were addressed in the context of the audit of the FS as a whole and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters
- Separately **detail each key audit matter** using an appropriate sub-heading
- Include reference to the related disclosure (if any) in the financial statements
- State why the matter considered to be one of the most significant in the audit (is therefore KAM), and how the matter was addressed in the audit
- Prohibition on use of KAM disclosure in the following circumstances:
 - In substitution for expressing a modified opinion (and conversely, KAM that doesn't trigger modification of the auditor's opinion would need to be communicated as KAM)
 - When the auditor disclaims an opinion on the financial statements.

ISA 701 & ISA 570

Going Concern

- ▶ KAM disclosures may include significant auditor judgments around matters that indicate going concern uncertainty where auditor concludes no material uncertainty exists (and is adequately disclosed)
- ▶ If auditor concludes that a material uncertainty exists (and is adequately disclosed), the KAM disclosure requirement is under ISA 570
 - ▶ i.e. required EoM paragraph headed “Material Uncertainty Related to Going Concern”

New Auditor Reporting

Effective date and application

- ▶ The new/revised ISAs are effective for audits of financial statements for periods **ending on/after 15 December 2016**,
 - ▶ i.e. first mandatory implementation under IAASB specified effective date is for audits of financial statements for periods ended on **31 December 2016**
 - ▶ early adoption was permitted:



What are the key practice risks?

Auditor Reporting

Methodology considerations

Important point #1:

The audit has not changed! The way the audit is performed does not change. Documentation of significant auditor judgements and communications with those charged with governance will be important areas of the audit process.

Important point#2:

However, the enhanced/expanded disclosures required for the auditor's report has a significant impact on the **risk profile of the audit engagement** (i.e. scope for greater scrutiny of the auditor's work and auditor judgments). Auditors carry increased risk arising from possible regulatory challenge/action coupled with relatively greater liability exposure

Auditor Reporting

Methodology considerations

Key areas of expected impact on methodology and its implementation:

- ▶ **Enhanced communications** with management, boards and audit committees
 - ▶ proactive discussion of significant areas of risk and related audit findings and auditor findings at key phases of the audit
 - ▶ considerable focus on areas of significant management judgment and significant auditor judgment (accounting estimates, estimation uncertainty in valuations)
 - ▶ also fraud risk and non-compliance with laws and regulations
- ▶ **Group and inter-office reporting arrangements**: group reporting roll up -- what should feature as KAM in group report if reported by component?
- ▶ **Audit documentation** of all KAM disclosures is a critical area for audit quality
- ▶ Expect **increased regulatory scrutiny** for audits of listed entities/audits regarding KAM disclosures

QUESTIONS or FEEDBACK?

