

# SPECIAL GAAP REPORT

## ‘The new Auditor’s Report’

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*In this Special GAAP Report, Justin Reid discusses ramifications of changes to international and Australian auditing standards on reporting and, in particular, the introduction of key audit matters. While some of the larger firms have jumped on the bandwagon of change, we remain sceptical.*

### A little knowledge can be a dangerous thing

#### IMAGINE THIS SCENARIO

*You meet a friend in the street. You stop to ask, “How have you been?” Your friend replies, “Well. The doctor and I had lengthy discussions about my alcohol intake, but the tests conducted so far seem to be negative so there’s nothing to worry about”.*

**Ponder this as you read below.**

### You were the lucky ones

If you are already an auditor reading this, you are very lucky, one of the fortunate few, the special ones.

One day you will be able to tell your grandchildren, “I was an auditor in the good old days”.

Now, I don’t mean before ‘force of law’ (2006). I don’t even mean before ‘Clarity’ (2010). I mean right now (2015) when all auditors’ reports are equal, when one firm’s report says essentially the same as any other. When you may report either a pass or fail on financial statements, when you and your audit clients can quietly discuss the appropriate treatment of a balance or transaction without the whole world knowing how, what and why you reach your answers.

Ah, the good old days! Well, the new Auditor’s Report is coming, and those good old days are over.

### What has changed?

The world changed on 15 January. The International Auditing and Assurance Board (IAASB) issued its new and revised suite of reporting standards (and conforming amendments to eight other standards), heralding the biggest change to an auditor’s role in living memory.

The IAASB has revised the following standards:

- ISA 260 – Communication with Those Charged with Governance
- ISA 570 – Going Concern

- ISA 700 – Forming an Opinion and Reporting on Financial Statements
- ISA 705 – Modifications to the Opinion in the Independent Auditor’s Report
- ISA 706 – Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report

And the IAASB has issued a brand new standard:

- ISA 701 – Communicating Key Audit Matters in the Independent Auditor’s Report.

In essence the changes to an audit report will include:

- ✓ *Opinion section* – this will be presented first, followed by a ‘Basis of Opinion’
- ✓ *Going Concern section* – a new section titled “Material Uncertainty Related to Going Concern” will be required in such cases as well as enhanced descriptions of the respective responsibilities of management and the auditor with respect to going concerns, and
- ✓ *Independence Statement* – an affirmative statement about the auditor’s independence as well as fulfilment of relevant ethical responsibilities with disclosure of the origin of the requirements, that is, the *Corporations Act 2001* or *Code of Ethics for Professional Accountants*.

However, the most controversial and game-changing addition will be mandatory for listed entities and voluntary for other entities.

- ✓ *Key Audit Matters (KAM)* – from the matters communicated with those charged with governance, the auditor is required to determine those matters that were the most significant in the current period and report them. When describing KAMs, an auditor is required to include:
  - Why the matter was considered to be one of the most significant
  - How the matter was addressed in the audit, and
  - A reference to the related financial statement disclosure.

## Why?

According to their supporters, we need the changes so that the auditing profession can continue to be relevant! Relevant? When did auditors become irrelevant? Did we miss a memo or something?

Apparently, users of the current 'pass/fail'-type report felt they were not getting enough relevant or informative intelligence on the entities on which they were reporting. Initially, one of the reasons put forward for the project was that financial-reporting standards were becoming too complex; analysts wanted auditors to provide more information in their reports.

It would appear that the dozens (sometimes hundreds) of pages of financial information contained within financial statements are not complete enough for analysts and investors; auditors are being asked to provide that missing piece of information that is supposedly in "the public interest".

Mooted benefits of the changes also include increased confidence in reports, enhanced communications between auditors and those charged with governance, and a renewed focus on matters to be reported, resulting in auditors' greater professional scepticism.

## Implications for management and those charged with governance

The impact of including KAMs within audit reports is likely to be significant for management and those charged with governance. For listed entities, imagine the prospect of their auditor "commenting" publicly about significant matters addressed during an audit period.

- What impact might an auditor's KAMs have on public perception of the entity?
- What if an auditor's KAM is seen as a negative or positive impact upon share price?
- Can communications between management and auditor maintain their robustness?
- What input might the entity have in defining KAMs and how they will be described in a report?

Another so-called benefit of the changes will be an increased attention by management and those charged with governance on disclosures within financial statements.

There is no doubt that the result will be increased management attention, but whether a benefit will result remains to be seen. Auditors will be responsible for wording KAMs. They will be expected to describe how a significant matter was addressed during the audit. But questions remain.

- Will the auditor's point of view necessarily agree with the view of management and governance? Just because the auditor has been able to reach a decision to provide an opinion does not mean that managers necessarily agree with him or her. What will the auditor write in those cases?
- How descriptive will the auditor be with respect to the resolution of contentious or disputed accounting treatments?
- Will some auditors stay silent on the initial position of management or will they say that management was originally opposed to the final treatment?
- How will the auditor describe managers' attitudes? It remains to be seen, but will all auditors be able to describe honestly the discussions that transpired and what those involved thought of them?

- Will the need to maintain a positive and effective working relationship between auditor and client result in watered-down or boilerplate descriptions of management's viewpoint?

We will all watch with keen interest how auditors will describe (or more likely, not describe) the dealings with management over KAMs.

Some further points to ponder. Will market forces drive this 'enhanced' audit reporting beyond the listed entities? Will it be perceived to be best practice and applied for non-listed entities, for example, substantive public entities and not-for-profits? Interesting, our New Zealand cousins have flagged that they will look to a scope-extension decision in 2018.

## Implications for auditors – More than just a new-looking audit report

The impact of the changes (in particular KAMs) on auditors cannot be under-estimated. Not only will there be a very different looking audit report, but the dynamic of the client/auditor relationship will be forever affected.

'Standard' auditors' reports will no longer exist. They will be replaced by longer documents that contain more detail. They will be more descriptive, include subjective wording and be more open to interpretation than the auditor might have intended.

## Legal issues and considerations

Our good friend Stephen Newman from legal firm Hope Earle notes that the new ISAs raise several issues. Some of them are:

- Auditors should review their professional-negligence insurance policies to see whether any change in policy wording and cover is required. Your insurance broker should be consulted
- Auditors should review their engagement letters to see whether they should be changed, particularly with respect to liability issues
- Auditors should remember that they have only qualified privilege for what they say in an audit report. If they are motivated by 'malice' (as understood in defamation law), the qualified privilege protection will be lost
- By having to 'say more' in an audit report, will auditors be handing extra ammunition to class action and other lawyers and encourage more disputes and litigation with clients and third parties?
- Will auditors have to engage lawyers to review what they say in audit reports about KAMs and other matters of opinion, including the 'close-call' scenario, to ensure that they are on the 'right side of the line'?

## Expected effects on auditors

Some of the expected effects on auditors are likely to be:

- ✘ *Increased time and cost associated with the determination of KAMs.* Additional time will be required to determine which matters should or should not be reported in the first place. The engagement partner will need to consider seriously the wording used in the descriptions of KAMs as well as the need to consult with management and those charged with governance with respect to KAMs. Extra time and money is also likely to be spent as firms' own quality-control systems ensure that appropriate consultations are had between technical teams and the engagement partner responsible for the opinion.

- ✘ *Increased risk that the audit report might be taken out of context when read without the financial statements.* While an audit report will instruct users to refer to particular areas within the financial statements, there is a real risk that users might skip the step and use the audit report to identify significant matters rather than reading and fully appreciating financial statements.
- ✘ *Perception is reality.* The more that is said, the more it may be misinterpreted. Remember our friend earlier who was talking about his medical tests? That kind of statement would be disturbing, right? You would immediately have concerns for your friend's health and you would certainly want to know more. This is how many observers might see a KAM. They will have more questions, want further information, and seek interpretation or explanation of things they might have misunderstood. Sometimes a little knowledge is a dangerous thing.
- ✘ *Summarising can be perilous.* When it comes to reporting on KAMs it is important to remember that these significant matters will not necessarily be easy to summarise. Often they will relate to highly subjective and possibly interpretative accounting treatments that might have been the subject of many hours of discussions, analysis and testing. How easily will this be translated into a succinct and easy-to-follow paragraph (or two) within a report? Will a misinterpreted description by the auditor be pounced on? Will the auditor be able to convey fully the rationale behind how or why a decision was reached?

The inclusion of KAMs will have an unprecedented impact on auditors and goes to the very core of their role. Many (including this author) believe that including KAMs in auditors' reports is an unnecessary and unwarranted knee-jerk reaction to the global financial crisis and the oft heard catch-cry: "Where was the auditor"? We will leave that argument for another day.

The true extent of the impact cannot possibly be understood until the changes are made and become real. The ramifications of publicly reporting key audit matters in the wrong way may have serious ramifications for both entities and auditors.

### What needs to be done now?

Right now we have to wait.

The Auditing and Assurance Standards Board (AUASB) has agreed to adopt the IAASB's effective date for the new audit reports for financial-reporting periods ending on or after 15 December 2016. Yes, that is ending 15 December 2016, so in reality the first reporting period commencement date is likely to be 1 January 2016.

The AUASB is yet to release its exposure draft on the changes. Consultative meetings during April are likely to contribute important feedback, and an ED is expected shortly thereafter.

As with the vast majority of Australian auditing standards, differences between ours and the international equivalent are unlikely. There might, however, be modifications. It is also not improbable that we might see a different scope for the mandatory application of KAMs.

Australia may decide upon a narrower scope than simply 'listed' entities and restrict mandatory reporting of KAMs to Top-200 entities. Conversely, as some very important members of the auditing community have pointed out, 'an audit is an audit' and that all auditors' reports might be expected to include KAMs.

At this stage (early April 2015) we await, with great expectations, the first signs from the AUASB on how Australia will be affected by the international changes.

Auditors will then need to start the communication process with clients affected as well as turning their attention to procedures to overarch the new reporting requirements.

Rest assured, however, that auditing will never be the same again.



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Justin Reid is an expert in auditing and professional standards with specific expertise in firm-wide quality control and audit training. He is team leader, assurance and risk management. He was previously Professional Standards Manager with the WHK Group, and was responsible for technical standards, quality-control policies and procedures, and training. Justin is also a content provider for Auditflow audit modules and was a contributor to the CAANZ Audit Manual and Toolkit. He is also author of *GAAP Consulting* publications 'Introduction to the Clarity Auditing Standards' and 'Clarity Auditing Standards – The Detailed Analysis'.



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Stephen Newman is a corporate and commercial lawyer who also has considerable litigation and dispute-resolution experience. He has been a partner in well-known Melbourne CBD law firms and is now with Hope Earle Lawyers. He works closely with the *GAAP Consulting* team in providing advice on a range of matters, including the application of the Corporations Act 2001 to audit practice, the ASX Listing Rules, the application and interpretation of the auditing and accounting standards, audit-practice risk management, fraud detection and investigation, preparation of section 311 reports to ASIC, dealing with ASIC investigations and enforcement proceedings, and auditor negligence and other civil claims.

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