THE NEW AUDITOR'S REPORT

Perspectives on its Impact

The independent auditor's report is the auditor's key communication to the shareholders and other users of the financial statements. After many years of audit reports that merely provided a 'pass/fail' conclusion, the landscape has changed. By ***Zuleka Jasper***

WHY THE CHANGE?

The external audit is an independent and objective process that aims to conclude whether the financial statements fairly present, in all material respects, the financial affairs of the entity. The mere 'pass/fail' conclusion did not provide insight into the audit process and the value of the external audit. With the continuous focus on transparency, it is safe to say that the audit report, as we knew it, did not keep up with the needs of the users of the financial statements.

When the International Auditing and Assurance Standards Board (IAASB) embarked on the Auditor Reporting reform project, it undertook research, public consultations, and stakeholder outreach, including global roundtables. The conclusion was that enhanced auditor reporting is critical to influencing the perceived value of the financial statement audit.

WHAT ARE THE KEY CHANGES?

The July 2015 issue of ASA included several articles on the auditor's report; refer to *The new auditor's report* article for a detailed analysis of the report. In summary, the key changes are as follows:

For *all* audits of financial statements:

- *The opinion section is presented first* – users will see the overall opinion first and in doing so it sets the tone for the rest of the report and contents thereof.
- *Enhanced reporting on going concern* – the responsibilities of the auditor and management are clearly defined. In addition, the report allows for specific commentary about the entity's ability to continue as a going concern if the auditor concludes that a material uncertainty exists.
- *A clear statement about the auditor's independence and compliance with the relevant ethical requirements.*
- *Enhanced details about the auditor's responsibility and key features of the audit* – the aim is to provide insight into the audit process.

For *listed* entities (voluntary for other entities):

- *The inclusion of key audit matters (KAMs)* – KAMs are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the period under consideration. Also refer the April 2015 issue of ASA, Focus on key audit matters, and the July 2015 issue, *Key audit matters: Questions and Answers* for further details.
- *Disclosure of the name of the engagement partner* – In South Africa, this requirement is already in place for all entities as a result of the Independent Regulatory Board for Auditors (IRBA) requirement in this regard.

It is worth noting that some industry regulators have mandated the disclosure of KAMs in the auditor's report, despite the fact that the entity is not listed, for example the Council for Medical Schemes and the Registrar of Collective Investments Schemes. There is no doubt that other regulators will follow in due course; the South African Reserve Bank has already indicated that it is considering a similar requirement for registered banks.

The new and revised standards are applicable for financial years ending on or after 15 December 2016; however, early adoption is permissible. In light of the small number of early-adopter reports in South Africa, users of financial statements can look forward to an exciting new year. Some of the South African entities where the auditors early-adopted include: Imperial Holdings Limited, Attacq Limited, Royal Bafokeng Platinum Limited, Massmart Holdings Limited and JSE Limited.

THE IMPACT FOR DIFFERENT STAKEHOLDERS

Auditors

Historically the auditor's report as such, due to its standard format, required little effort. Going forward the auditor has to consider the KAMs during the planning phase of the audit and ensure that the entire audit process and documentation thereof effectively and sufficiently deal with the KAMs. Commencing to draft a report already during the planning phase of the audit might assist in developing appropriate audit responses to the KAMs.

The reality is that appropriate articulation of the KAMs will take time and skill. It will require the input of the audit partner and also that of the different quality control processes within the audit firm.

Although the new and revised auditor reporting standards do not mandate concluding on each KAM, the auditor may decide to indicate the outcome of the audit procedures. Articulating such conclusion is equally challenging to articulating the KAM, and should be approached with caution.

Communication with those charged with governance (TCWG) should also occur much earlier to allow for adequate discussions.

Consider the following good habits when drafting the audit report:

- Bear in mind the audience and write in a manner they will understand and that will capture their attention.
- Be very specific on the KAM and the impact to the entity.
- Explain why the matter is a KAM.
- Include appropriate references to the financial statements; the auditor's report should not include any new information.
- Be concise.
- The use of terminology should steer away from audit jargon and be consistent.
- In future years a mere copy of the prior year audit report is just not good enough.

In the United Kingdom, the last bullet proved to be most difficult. It was noted that auditors find it challenging to bring something new to the audit report in future years and users of the financial statements might find the auditor's report less valuable as a result.

The finance team

The audit report will include references to the financial statements. It is important that the financial statements include all the relevant disclosures to ensure that the KAMs in the auditor's report merely refer to the financial statements and not include new information.

KAMs that relate to legal or other regulatory matters might warrant the review of the company's legal counsel.

Ordinarily, the different reports and elements within the annual report are drafted by different preparers.

It is important to perform an overall review to ensure that there is consistency across all reports, including the auditor's report. This might take more time than in previous financial years.

Preparers of financial statements might find that planning the financial statement preparation process should take place much earlier than before.

The audit committee

The identification and articulation of the KAMs should result in more robust discussions and debates between the audit committee and the auditor. This could potentially result in a better understanding of the audit process and the significant issues; however, it could also require more time.

The draft King IV Report requires that the audit committee report include disclosure on significant audit matters; which in essence is the counterpart of KAM in the auditor's report. It also expands on the requirements of the Companies Act 2008 on matters to be dealt with in the audit committee report.

This is aligned with the requirement by the UK Governance Code that audit committee reports should deal with significant issues that the committee considered in relation to the financial statements. Needless to say, this will require additional time and involvement of all the audit committee members.

Shareholders and other users of the financial statements

Historically shareholders and other users of the financial statements might have spent very little time on the auditor's report. As the auditor's report is addressed to the shareholders of the company, it implies that the KAMs were identified with these users of the financial statements in mind. Shareholders and other users of the financial statements should find that the KAMs are aligned with their concerns and hence provide them with better insight into those matters.

Users of the financial statements should consider using the auditor's report as the point of reference in reviewing the rest of the financial statements.

Investors might find it useful to compare audit reports of different entities within the same industry; this could provide valuable input as to the key issues in those industries.

WILL THE NEW AUDITOR'S REPORT REALLY MAKE A DIFFERENCE?

'Not only are auditors' reports now providing better information about the nature of the audit process and of the key judgements being made, they also now offer a more useful independent perspective on the companies they audit.' – Marek Grabowski

As noted earlier, the new auditor's report is aimed at increased transparency about the audit that was performed. This should increase the confidence of users of the financial statements in the external audit process.

The contrary could also be true. One can only imagine that users of financial statements will compare the audit procedures in response to KAMs within certain industries and in cases where the nature and extent of the audit procedures are considered to be less appropriate, it could decrease the perceived value of the audit.

It could be argued that auditors will enhance their audit procedures which in turn will impact positively on audit quality.

Considering the definition of KAMs, the report will focus the attention of users of the financial statements on the important account balances and disclosures in the financial statements and in turn enhance their understanding of the entity. Users of the financial statements should be able to use this information to have more meaningful engagement with the entity's management.

The discussions between the auditor, management, and the audit committee should deepen resulting in a clearer focus on the items that really matter.

The focus on KAMs could also indirectly drive the quality of financial statements.

WHAT ARE THE AUDIT COST IMPLICATIONS?

As with most other changes in legislation, regulations, etc, there will be some supplementary efforts on the part of the auditor, management, and the audit committee. As we all know, the audit efforts do not come without an invoice. Feedback from some auditors in the UK suggests that the additional costs were not material. Having said that it is important to keep in mind that the preparation of the new audit report will require the time and effort of the more experienced audit team members and that those resources are ordinarily more expensive.

It is in the best interest of the auditor and also the company that the auditor spends the appropriate amount of time and effort on the report to ensure that the KAMs are properly articulated.

WHAT DOES THE FUTURE HOLD?

The world is ever changing and to remain current the audit profession will continue to change. The new and revised auditor reporting standards are merely one of the changes that we will see in the years to come. Hopefully the transparency that it brings will confirm the importance of the independent external auditor and the value it brings to the financial markets.

SOURCES

International Auditing and Assurance Standards Board (IAASB) – Auditor Reporting page.

International Standard on Auditing (ISA) 700 (revised), *Forming an Opinion and Reporting on Financial Statements.*

ISA 260, *Communication with Those Charged with Governance.*

ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report.*

Speech by Marek Grabowski, Director of Audit Policy, Financial Reporting Council, IBRACON, 6th Brazilian Conference on Accounting and Independent Auditing, 13 June 2016.

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