The New Auditor’s Report

Brief for Boards and Audit Committees

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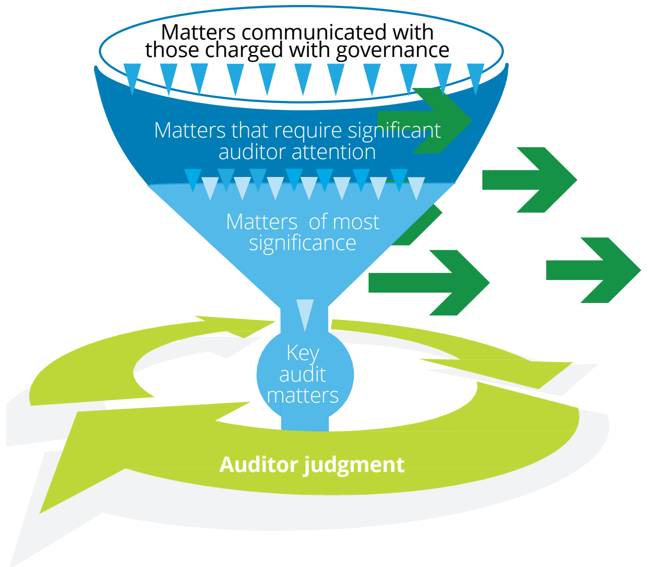
Background
An audit report is a culmination of an audit process and such report presently contains a simple pass/fail opinion of the auditor on a set of financial statements. Therefore there has been an urgent need to enhance the auditor report, thereby making it more useful to the users of the financial statements. The Indian auditing standards consistent with the International Standards on Auditing has made substantial changes in the reporting requirements by auditors which will be effective for audits of financial statements for periods beginning on or after 1 April 2017.

The objective of this publication is to provide boards and audit committees a bird's eye view of one of the main changes in auditor reporting.

What has changed?
There will now be a paradigm shift in the content of the auditor's report for listed entities[1]. This has been introduced through a new auditing standard[2] that requires inclusion of a separate section on 'Key audit matters' in audit reports. Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance[3].



Why the change?
Enhanced transparency to facilitate users of financial statements in understanding significant judgements made by the auditor in forming his opinion on the financial statements, since they are directly related to areas of significant management judgement in preparing the financial statements.

[1]For entities such as investment trusts that are not companies, but have their securities listed on a stock exchange, the requirements of the enhanced auditor reporting would apply.
[2]Standard on Auditing (SA) 701, Communicating Key Audit Matters in the Independent Auditor's Report.
[3]Para 8 of SA 701

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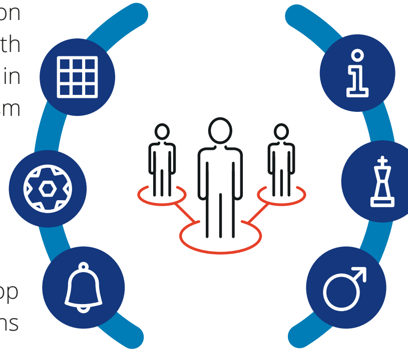
Benefits for different stakeholders:

Promotes meaningful early interaction between auditors and those charged with governance and management resulting in increased professional skepticism

Assists investors to make more informed decisions and therefore increase in confidence

Enables analysts develop industry comparisons



Provides more transparency and therefore possibly lesser interference by regulators

Facilitates easier access to funds to the entities

Offers more meaningful insights to lenders into how the company is managed

Does this new reporting limit or enhance responsibility?

Aligned with the enhanced responsibilities cast on independent directors by the Companies Act, 2013, which requires them to satisfy themselves on the integrity of financial information, etc.

This change is transformational in that it empowers the users of the financial statements. The typical 'boiler plate' report will now become a 'speaking' report, thereby raising the level of accountability to a totally different realm. It could probably cause significant direct interaction between auditors and shareholders at annual general meetings. The enhancement facilitates bridging not only the expectation gap but also the performance gap. Auditor failures could be alleviated to a large extent.

Increased responsibility on management, audit committees, and board of directors:
- Transparent communication to auditors of all matters that are of significance
- Robust challenge of what is laid out in the public domain by the auditors in their report
- Challenge in completeness of matters that are included in the audit report
- Alignment of matters included in the audit report with the information available in public domain / industry matters / resolutions passed for various matters (for e.g., related party transactions)
- Increased challenge by users of financial statements (including regulators)

For auditors:
- No change in the current audit process
- Now specifically required to communicate to those charged with governance, identified significant risks (i.e., matters requiring special audit consideration)
- Increase in professional skepticism since key audit matters, their identification, procedures performed etc., would now be specifically spelt out in the audit report
- All matters that they believe are key audit matters are included in the audit report, despite a potential challenge from management or those charged with governance
- Increased challenge by users of financial statements (including regulators)

How does this impact an organization in terms of cost, preparedness, and disruption?

Key audit matters being a sub-set of the matters that are discussed with those charged with governance, increased interaction between auditors, management and those charged with governance would result in significant amount of time to be invested in determining wordings in the key audit matters section of the audit report. This is expected to increase cost.

To enable consistency in the reporting of key audit matters with the disclosures in the financial statements, good start points to ensure preparedness would be:

- Previous year audit report redrafted to suit the new requirements
- Significant accounting policies, especially in an Ind AS scenario where there is a specific need to discuss significant judgements and estimates by the management
- Significant resolutions passed at the various meetings of the board and its committees
- Significant matters informed to the Stock Exchanges by the company
- Significant matters that are specific to the industry, including matters of litigation

While disruption is not expected, substantial amount of time is required to be set aside for this important reporting requirement.

Which are some potential key audit matter areas?

- Certain complex areas relating to revenue recognition
- Provisions and contingencies
- Taxation matters (multiple tax jurisdictions, uncertain tax positions, deferred tax assets)
- Assessment of impairment
- Put arrangements over non-controlling interests
- IT systems and controls
- Any industry matter

Sample disclosure of a key audit matter

Illustration of how included in an audit report

Key audit matter[4]	How the audit addressed the key audit matter
Income tax and deferred tax	
Income tax: Due to the multiple tax jurisdictions within which the Group operates and the ambiguity of tax laws, determining the amounts which should be recognised for tax is subject to judgement and is thus a key audit matter. Management's judgement includes consideration of regulations by various tax authorities with respect to transfer pricing regulations and other tax positions. Where there is uncertainty, management makes provision for tax based on the most probable outcome. Management's disclosures with regards to the uncertainties are contained in note XX, while the income tax disclosures are contained in note XX.	We involved our tax specialists to evaluate the recognition and measurement of the current and deferred tax assets and liabilities. This included: – Analyzing the current and deferred tax calculations for compliance with the relevant tax legislation. – Evaluating management's assessment of the estimated manner in which the timing differences, including the recoverability of the deferred tax assets, would be realized by comparing this to evidence obtained in respect of other areas of the audit, including cash flow forecasts, business plans, minutes of directors meetings and our knowledge of the business.
Deferred tax: As disclosed in note XX, the Group has recognised deferred tax assets in respect of certain entities to the extent that it is probable that historical assessed tax losses will be realised. This requires management judgement in estimating future taxable income and is accordingly a key audit matter.	– Challenging the assumptions made by management for uncertain current and deferred tax positions to assess whether appropriate current and deferred tax provisions have been recognized and are based on the most probable outcome. We found the disclosures relating to the income tax and deferred tax balances to be appropriate.

[4]An extract from the Annual Financial Statements of Imperial Holdings Limited for the year ended 30 June 2015

Challenges in reporting

While reporting key audit matters in the audit report on standalone financial statements has its own set of challenges, this is expected to increase in joint audits and audits of consolidated financial statements. In the case of joint audits, planning is joint, performance is separate, reporting is joint and responsibility is separate. Therefore alignment between joint auditors is critical and acts as the fourth dimension to the story of audit reports.

In the case of consolidated financial statements, existence of multiple components adds a new dimension to reporting. This can transcend to a new level, when there are:

- Unlisted components in India not mandatorily requiring reporting of key audit matters; and/or
- Entities incorporated outside India (some jurisdictions may not mandate reporting on key audit matters / key audit matter reporting not mandatory for unlisted entities).

In the above cases, it appears that the group auditor will be saddled with the onus of discussing with those charged with governance and the component auditor to determine matters that fall within the definition of key audit matters. Since the audit work will be performed by the component auditor, it is unclear as to how much responsibility will the group auditor take up, especially when there is no change to India Standards on Auditing wherein responsibility is separate in the case of components audited by other auditors. In the case of associates or jointly controlled entities, it becomes all the more difficult in the absence of control by the parent. These are expected to substantially increase the roles and responsibilities of those charged with governance of the parent entity.

Our insights

While there are challenges in implementing this enhanced reporting requirement, it is a given that there is no gain without pain. To make this a success and address the prime objective of transparency in reporting, auditors and those charged with governance will need to interact early in the day to ensure that there is a smooth transition from the old reporting to the new reporting. This is more so in times of rotation. Auditors in turn will also require to hone their drafting abilities and be focused and crystal clear on what the requirements entail. Anything attempted in the last minute is designed to fail. Some key takeaways would be to engage early, re-draft the previous year report and interact throughout the year. Auditors need to be prepared to be challenged on what has not been reported, since there is a likelihood for treading on a path where a user may believe that what was not reported, was not audited.

Deloitte.