KPMG

cutting through complexity

The New Auditor's Report

Greater Transparency, More Relevant

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New Auditor's Reports that Promote Greater Transparency and Higher Informational Value:

A Global Trend to Enhance the Value of the Audit

David Ko
Head of Audit, KPMG China

At KPMG China we welcome the opportunity to embrace this global trend. The new changes to the auditor's report will allow us to demonstrate to shareholders the value of our audits, by giving key insights into how we ensure that each clean audit opinion is justified.

We know that the investment community is keen to hear from us and we are looking forward to this new era of greater transparency and understanding.

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Background

Prompted by the global financial crisis, the investment community has been calling for greater transparency from auditors to give users of financial statements more insights into the audit and the auditor's roles.

Standard setters internationally have responded by exploring how to re-vamp the auditor's report to provide more than a pass/fail opinion. In 2013 the auditors of UK listed companies were required for the first time to include a discussion of the key risks identified in the audit and how these were addressed in their published reports. In January 2015, similar requirements were introduced into the International Standards on Auditing (ISAs) with an effective date of financial years ending on or after 15 December 2016.

We expect this will fundamentally change the reporting by auditors around the world. Like many countries, auditing standards in Mainland China and Hong Kong SAR are closely converged with ISAs. Local auditing standard setters are currently in the process of considering revisions to their standards but our expectation is that these new developments will be embraced both in full and in time to meet the international effective date.

Experience from the UK has shown that the investment community is unimpressed with boilerplate, bland wording. They want to hear specifically about the issues that the auditors focused on the most – the significant areas of judgment or those matters where they had the most robust discussions with those charged with governance (being the audit committees in most cases).

Experience also shows that the impact of the new requirements is not limited to the auditor's report. A welcome side-effect has been improved disclosure elsewhere in the annual report or more broadly of information relating to these issues so that the auditor is not revealing any new information about the company's affairs which is not already disclosed by the company.

Impact on Those Charged with Governance and Management

- **More robust communication** between those charged with governance, management and the auditor, especially on the key audit matters
- **New Key Audit Matters (KAM) section** may provide users of financial statements with the opportunity to further engage with management and those charged with governance about matters relating to the entity
- **Increased attention** by management and those charged with governance to the disclosures in the financial statements referred to in the auditor's report

Lessons from the UK experience on the new Auditor Reporting

- **The focus needs to be on communication not compliance** - investors want to learn more about what the auditors focused on the most, why they thought it was important and how they addressed the matter in their audit
- **Boilerplate wording does not satisfy this thirst for knowledge** – investors want to learn something about the audit that is not already obvious from the "clean" audit opinion
- **Information disclosed elsewhere by the company should provide the context for the auditor's report** - whether it is risks facing the company, significant judgements, major transactions or a new IT system, investors need to hear about it from the company first

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What will the new Auditor's Report look like?

INDEPENDENT AUDITOR'S REPORT
To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion
We have audited ……
In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its 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 ……We are independent of the Company…

Audit opinion at the beginning, followed by a Basis for opinion paragraph. Affirmative statement about the auditor's independence

Key Audit Matters
Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the 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]

Description of Key Matters in the Audit for listed entities, including WHY and HOW for each KAM

Information other than the financial statements and auditor's report thereon
Management is responsible for the other information. The other information comprises the [information included in the X 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.
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.

New Other Information section to explain responsibilities of management and auditors, and whether we have any findings.

Auditor's Responsibilities for the Audit of the Financial Statements
Our objectives are to obtain …
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 financial statements,....
§ Obtain an understanding of internal control relevant to the audit …
§ 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 …
§ Evaluate the overall presentation, structure and content of the financial statements …

Enhanced description of the Auditor's Responsibilities. This is standard wording for every auditor's report and can be moved to an appendix to keep the auditor's report focused on the KAMs

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

Disclosure of the name of the engagement partner for listed entities*

* Although this is a new requirement under ISA 700 (Revised), it would not be a new requirement for auditor's reports issued in Mainland China in accordance with China Standards on Auditing, as disclosure of the names of the two signing CPAs is already required.

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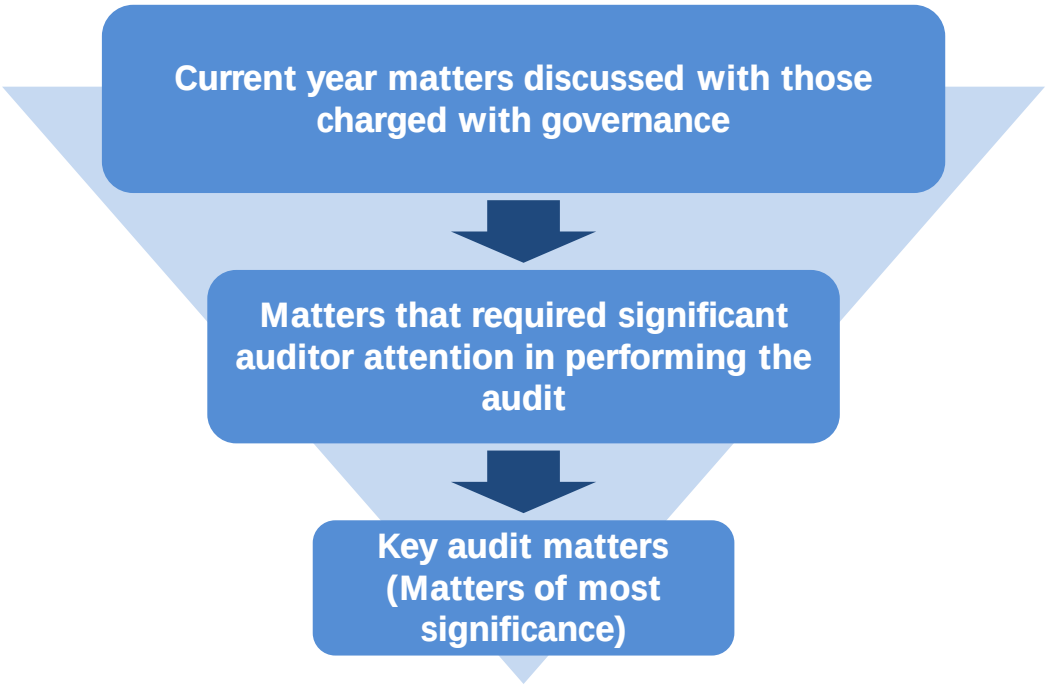
A closer look at key audit matters

Key audit matters are those matters that in the auditor's judgement were of most significance in the audit – i.e. the areas where the auditor focused the most during the audit. Key audit matters should be identified from amongst those discussed with those charged with governance as illustrated below:



Key audit matters may include:

- areas of complexity and significant management judgment which affected the auditor's overall audit strategy, allocation of resources and extent of audit effort;
- events/transactions that had significant effect on the financial statements or the audit;
- critical accounting estimates and related disclosures;
- matters that pose challenges to the auditor in obtaining appropriate audit evidence or in forming an opinion on the financial statements; or
- matters where the auditor has consulted with others.

Describing a key audit matter in the audit report

The description of a key audit matter will be tailored to the company and will:

- explain why the matter was considered to be of most significance in the audit;
- describe how the matter was addressed in the audit; and
- provide a reference to any related financial statements disclosures.

With respect to how the matter was addressed in the audit, the auditor may describe any of the following elements, or a combination of these elements:

Aspects of the auditor's response that were most relevant to the matter	**A brief overview of procedures performed**	**An indication of the outcome of the auditor's procedures**	**Key observations with respect to the matter**

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Key audit matters examples from UK audit reports

The new style UK audit reports have attracted the attention of the investor community and media. Investors appreciated the insights and found the usefulness of the report to be a pleasant surprise. In particular, the discussion of the risks identified and addressed in the audit (the KAMs, using ISA terminology), has led to a greater understanding of what auditors do, thereby increasing public confidence in financial reporting. Reports which were specific to the company were preferred whilst boilerplate comments were felt to be less useful.

Studies of the first year of implementation also showed that stakeholders recognised that the enhanced reports issued in the UK were just a beginning. The trend of improvement and innovation has continued into the UK's second year of adoption, with granularity of discussion of key audit matters, and a reduction in the number of boilerplate observations, becoming more of the norm across a wide range of companies. In this way, investment community interest in the reports has been sustained, and a high bar has been set for those countries only now beginning their journey under ISAs.

Here are some examples of how KPMG in the UK discussed the risks facing their clients and the audit procedures adopted to address those risks:

Impairment of property, plant and equipment

Risk

The economic climate and levels of competition remain challenging for the Group. The Group has completed a Strategic Review, details of which were announced in the half year statement, and as a result has decided to close or curtail some of its operations. There is therefore a risk that the impairment charge may be misstated. Determining the level of impairment involves forecasting and discounting future cash flows and estimation of recoverable amounts which are inherently uncertain. This is one of the key judgemental areas that our audit has concentrated on.

Our response

Our audit procedures included, among others, considering the impairment risk associated with the following different types of asset:

- In respect of assets within shops which continue to trade we critically assessed and challenged the Group's impairment model. This included consideration of the discounted cashflow forecasts on a shop by shop basis and assessing the cashflow forecasts against the historical performance of those shops and against the Group's budgets. We assessed the appropriateness of the discount rate including benchmarked it against similar national retailers. We also recalculated the impairment model to assess the sensitivity of the key assumptions including growth rate and discount rate;
- in respect of fixtures and fittings within shops which had either been closed or were identified by the Group for closure as a result of the Strategic Review, we critically assessed the Group's identification of assets that were obsolete, using our experience of the Group and review of historical experience, whether such assets have any recoverable value;
- in respect of land and buildings which had been identified and announced in the half year statement as surplus to requirements, or where development plans had been aborted, we considered whether such assets had been written off or impaired where necessary down to their recoverable amounts. We critically challenged the Group's assumptions in relation to recoverable amounts with reference to external third party valuations obtained by the Group. We considered the qualifications and independence of the valuers and the movement in market values of property in relevant locations; and
- we have also considered the adequacy of the Group's disclosures about the degree of estimation involved in determining the amount of impairment and the sensitivity to key assumptions involved.

Extract from KPMG's auditor's report on Greggs plc's financial statements for the year ended 31 December 2013

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Carrying value of intangible assets

Risk

The Group has significant intangible assets arising from the acquisition of products both launched and in development. Recoverability of these assets is based on forecasting and discounting future cash flows, which are inherently highly judgmental. For products in development the main risk is achieving successful trial results and obtaining required regulatory approvals. For launched products, the key risk is the ability to successfully commercialise the individual product concerned.

Our response

In this area our principal audit procedures included testing the Group's controls surrounding intangible asset impairments and evaluating the Group's assumptions used in assessing the recoverability of intangible assets, in particular, revenue and cash flow projections, useful economic lives and discount rates. We also performed sensitivity analysis over individual intangible asset models, where there was a higher risk of impairment, to assess the level of sensitivity to key assumptions and focus our work in those areas. For products in development, a key assumption is the probability of obtaining the necessary clinical and regulatory approvals. Our procedures for products in development included critically assessing the reasonableness of the Group's assumptions through consideration of trial readouts, regulatory announcements and the Group's internal governance and approval process. We also interviewed a range of key Research, Development and Commercial personnel and compared the assumptions with industry practice where available. For launched products we challenged key assumptions including the size of the therapeutic area market, the product's projected share of this and expected pricing and associated costs. Our procedures also included holding discussions with relevant management personnel and challenging management's statements by reviewing analyst commentaries, consensus forecasts and retrospective assessment of the accuracy of the Group's projections. We also assessed the adequacy of related disclosures in the Group's financial statements.

Extract from KPMG's auditor's report on AstraZeneca PLC's
financial statements for the year ended 31 December 2014

Valuation of inventory

Risk

Inventory is carried in the Financial Statements at the lower of cost and net realisable value. Sales in the fashion industry can be extremely volatile with consumer demand changing significantly based on current trends. As a result there is a risk that the carrying value of inventory exceeds its net realisable value.

Our response

Our audit procedures were designed to challenge the adequacy of the Group's provisions against inventory by seasonal collection and included:

- Corroborating on a sample basis that items on the stock ageing listing by season were classified in the appropriate ageing bracket;
- Assessing the appropriateness of the provision percentages applied to each season and challenged the assumptions made by the Directors on the extent to which old inventory can be sold through various channels; and
- Considered the historical accuracy of provisioning and used the information obtained as evidence for evaluating the appropriateness of the assumptions made in the current year including how these compare to the experience in previous years.

We have also considered the adequacy of the Group's disclosures in respect of the levels of provisions against inventory.

Extract from KPMG's auditor's report on Ted Baker PLC's
financial statements for the 53 week period ended 31 January 2015

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New Auditor's Report Benefits Stakeholders

The implementation of the new and revised standards will represent a significant change in practice. The motivation for the changes is to make sure that the auditor's report continues to be worth reading. The changes are targeted at trying to close the expectation gap between what the public believes to be the job of the auditor and how it should be performed, and what the responsibilities of the auditor are and how they are performed in practice. Through the auditor providing more disclosures in the auditor's report, investors will be better equipped to engage with their companies and auditors about the audit.

The primary beneficiaries of these sweeping changes to auditor reporting will be investors, analysts and other users of the auditor's report and the audited financial statements. These benefits can only be realised with collaboration by all participants in the financial reporting supply chain. An important lesson learnt from the UK experience is that changes to auditor reporting need to be paired with corresponding and supporting requirements for enhanced reporting by boards and audit committees. This stems from the fundamental principle of corporate reporting that all information relating to the entity should be provided by the entity; the auditor should not be providing any original information. The US Securities and Exchange Commission (SEC) and the US Public Company Accounting Oversight Board (PCAOB) are anticipated to take a similar approach to that of the UK.

Reviving the Auditor's Report

Within the last few years, auditing standard-setting and regulatory bodies globally including the International Auditing and Assurance Standards Board (IAASB), the PCAOB and the European Commission (EC) each embarked on their respective initiatives regarding auditor reporting. These initiatives share the common aim to provide more useful information about the entity and about the audit itself beyond that currently provided to users by the entity and the auditor. With completion of some of these initiatives, a significant milestone has been achieved by the global auditing profession. We are now at the start of a new era with promises to "reinvigorate the audit, [and] substantively change [auditors'] behavior and how they communicate about their work," in the words of IAASB Chairman, Prof. Arnold Schilder. China Standards on Auditing have been converged with the International Standards on Auditing since 2006. The Chinese Institute of Certified Public Accountants (CICPA) is currently in the process of considering revisions to China Standards on Auditing.

After an accumulation of intense effort over the past six years, the IAASB issued sweeping changes to its auditor reporting standards on 15 January 2015. The new auditor's report will be effective for audits of financial statements for periods ending on or after 15 December 2016. The new requirements will bring about alterations to auditors' behavior. Management and those charged with governance are also expected to have to react to these new changes.

The aim of the changes is simple: to increase transparency, audit quality and enhance the informational value provided to users of auditor's reports.

Ultimately, it is hoped that these will lead to increased user confidence in audit reports and financial statements. The amendments to the auditing standards are expected to result in:

- Renewed focus of the auditor on matters to be communicated in the auditor's report, which could indirectly result in an increase in professional skepticism exercised during the conduct of the audit
- Enhanced communications between the auditor and those charged with governance
- Enhanced communications by the auditor to investors through disclosures of key audit matters in the auditor's report
- Increased attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report, thereby enhancing financial reporting

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A Role for All Participants in the Financial Reporting Supply Chain

The proposed changes to the auditor's report will impact on all participants in the financial reporting supply chain – not only auditors. Some anticipated impacts to management and those charged with governance, auditors, regulators and investors are mentioned below.

Management and Those Charged with Governance (TCWG)

International Standards on Auditing (ISAs) issued by the IAASB are not binding on management or those charged with governance. The new requirements in the auditing standards therefore do not (and are unable to) directly impose any requirements on management or those charged with governance.

As such, it is important for policy makers and regulators to consider the need to put in place complementary reporting requirements for preparers of financial statements and those charged with governance. This need is clearly demonstrated in the case of the UK. The linchpin of the UK's successful adoption of changes to the auditor's report lies in the timely roll-out of a comprehensive suite of proposals for directors, audit committees and auditors to simultaneously enhance corporate reporting and audit.

Notwithstanding the above, under the new audit reporting requirements, there will be increased interaction by the auditor with management and those charged with governance in particular regarding potential key audit matters. During such communications, management and those charged with governance will seek to gain a clear understanding from the auditors how the key audit matters were determined by the auditors, how they were addressed in the audit and the manner in which they will be reported in the auditor's report.

In face of this, management and those charged with governance should in turn pay greater attention to the relevant disclosures in the financial statements to which reference is made in the auditor's report. Management and those charged with governance should be concerned that original information about the company is provided by the company and not through the auditor's report. They should also be on the lookout for greater attention paid by regulators and investors to how significant auditing issues are being addressed by management and those charged with governance.

To ensure this, management and those charged with governance may consider it necessary that additional information be disclosed.

Because boards and audit committees play an important governance function over management within the entity, further specific considerations that they should pay attention to during this time include the following areas:

- Have the board and audit committee established an effective process for overseeing management's discharge of their responsibilities in regard to the financial reporting process?
- Have the board and audit committee established an effective process to work with management on addressing audit issues identified?
- Have the board and audit committee established an effective process for working with, and supervising the auditor?
- How do the board and audit committee ensure shareholders' interests are protected and that decisions made by management are in the shareholders' best interests?

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Auditors

The new reporting requirements are aimed at renewing the focus of the auditor on matters to be communicated in the auditor's report. Although ultimately the tangible outcome of these changes is to be seen in the auditor's report which is almost towards the end of the audit process, the extent to which the work of the auditor will be impacted is far wider.

Prior to the effective date, audit firms will have to update their audit methodologies to ensure they meet these new requirements. In the case of international audit networks, beyond updating their global audit methodologies, local member firms will also have to take into account national differences because for some of the changes to the auditor's report, flexibility for national standard setters to determine the manner of adoption is permitted at the local level.

Importantly, engagement teams will have to be appropriately trained on the new requirements. The nature of key audit matters brings about new challenges to auditors from a training standpoint. Determination and treatment of key audit matters will, by its nature, be unique to each engagement. The auditor will need to incorporate these considerations early in the audit planning stage and ensure sufficient deliberations are given to identifying these key audit matters during the conduct of the audit.

In addition, auditor behavior is expected to be influenced by the need for greater transparency; this in turn is expected to result in an increase in professional skepticism during the conduct of the audit.

The process of determining key audit matters will involve not just key members of the engagement team, but will require working closely with other supporting functions within the firm such as technical and risk management areas.

On interacting with audit clients, auditors are expected to have to engage in increased communication with management and audit committees particularly in relation to the determination of key audit matters to include in the auditor's report. Auditors will have the responsibility to help their audit clients understand how the key audit matters were determined by the auditors, how they were addressed in the audit and the manner in which they will be reported in the auditor's report. It may also be the case that auditors will have a lively discussion with management and those charged with governance regarding the corresponding disclosures in the financial statements. Needless to say, collectively, these additional procedures are expected to exert greater time pressure on the auditor in terms of completing the audit and issuing the auditor's report on time.

Policy Makers and Regulators

The Organisation for Economic Co-operation and Development's (OECD) Principles of Corporate Governance emphasises the responsibility for management to ensure timely and accurate disclosure is made on all material matters regarding the entity and the Board's responsibility to oversee the process of disclosure and communications. Further, ISA 701 "Communicating Key Audit Matters in the Independent Auditor's Report" points out that it is inappropriate for the auditor to be the provider of original information about the entity. Such information is the responsibility of the entity's management and those charged with governance.

As such, any disclosures made by the auditor in the auditor's report should be on the basis that those matters are already disclosed by those charged with governance or management.

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Auditing standard setters can only impose requirements on auditors; they do not have powers over boards and audit committees.

National policy and rule makers will need to assume the responsibility for putting in place such complementary reporting requirements on those charged with governance and management as appropriate.

Post implementation of the new changes to the auditor's report, it is anticipated that regulators will be reviewing the application of the new auditor reporting regime as part of their inspection programs. Regulators will be undertaking greater discussion with auditors to understand the decisions that they have made in relation to identifying the key audit matters included in the auditor's report. It may be the case that regulators will take their own view in relation to certain matters which they perceive are critical to the audit, but have not been included as key audit matters. Such additional information will provide further input into the regulators' assessment of audit quality both at the firm and engagement level.

Regulators will need to evaluate how to factor these new auditor reporting changes into their inspection and enforcement programs. Similar to the audit firms, regulators will also need to ensure inspection teams are adequately trained in this regard.

At a broader level, as advocates of investor protection and the public interest, regulators will need to assess whether the new auditor's reports are providing valuable information for users and whether they are stimulating dialogue about the audit as intended. Regulators will be formulating their views on the benefits versus costs of introducing these new changes to the auditor's report.

Investors and Other Users of Information in the Auditor's Report

Perhaps much of good news to be delivered is to the investing community and other users of the auditor's report. The primary beneficiaries of new changes to the auditor's report will be investors, analysts and other users of the auditor's report and the audited financial statements.

Investors can look forward to being better informed about the audit process and receiving individualised disclosures from auditors regarding the audit work done and findings of the audit. It is hoped that the new information can encourage enhanced communications between the investors and the auditors. In the event enhanced disclosures are provided by the entity, similarly, this may also encourage engagement by investors with management and those charged with governance on accounting and auditing matters.

However, this does not imply that no effort is required on the part of users of the auditor's report. Users need to invest time to gain a clear and proper understanding of the purpose of the audit and role of the auditors. Only with this will investors be able to appropriately use the new information in the auditor's report to inform their investment decisions, and other users for their respective purposes.

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