ICAEW

Dubai Financial Services Authority

ICAEW briefing paper

Extended audit reports: Exploring challenges and opportunities in implementation

Foreword

This paper has been produced with reference to the International Auditing and Assurance Standards Board (IAASB) and the UK Financial Reporting Council (FRC) publications, along with comments from the breakfast briefing jointly organised by the Institute of Chartered Accountants in England and Wales (ICAEW) and the Dubai Financial Services Authority (DFSA), on Thursday 26 May 2016 at DFSA.

The panel discussion was moderated by Michael Armstrong, Regional Director MEASA, ICAEW, and included the following panelists:

Bryan Stirewalt Managing Director Supervision, DFSA

Bryan joined DFSA in 2008 and has served as Managing Director of the Supervision Division since 2010. The Supervision Division includes prudential and conduct-oriented oversight of a variety of financial service providers. Inter alia, the Supervision Division oversees DFSA's role with auditors and credit rating agencies.

Richard Ackland Partner, KPMG

Richard is a partner focused on complex global manufacturers from an audit, treasury and risk perspective. He is engagement partner for Rolls-Royce Holdings Plc and leads KPMG's Corporate Treasury Services.

Edward Quinlan Audit Committee Member

Edward retired as managing partner of EY's UAE office in 2010, having been responsible at various times for the firm's offices in Saudi Arabia, Qatar and Jordan. He is a member of the Audit Committee of a very large diversified local family owned group, a public company and the International Cricket Council.

Umar Saleem CFO, DEPA

Umar has 25 years of experience in corporate finance, operations management, business consulting and restructuring across a broad spectrum of industries. He is currently working as Group CFO at DEPA, one of the world's largest interior fit-out firms, listed on NASDAQ Dubai with a secondary listing on the AIM market of the London Stock Exchange.

Introduction

IAASB released a revised standard (ISA 700 – Revised) in January 2015 which is compulsory for listed entities and comes into effect for audits of financial statements for periods ending on or after 15 December 2016. It was introduced in response to the need to improve auditor communications, recognising that users want more relevant information about the audit of financial statements to aid decision making, and as a basis for further engagement with the audited entity.

The revised standard addresses the auditor's responsibility to form an opinion on the financial statements along with the form and content of the auditor's report issued as a result of an audit of financial statements.

IAASB's 'At a Glance' publication[1,2] details the key enhancements to the auditor's report:

Mandatory for audits of financial statements of listed entities (voluntary for other entities):

- New section in the audit report to communicate Key Audit Matters (KAM); and

- Disclosure of the name of the engagement partner.

For all audits:

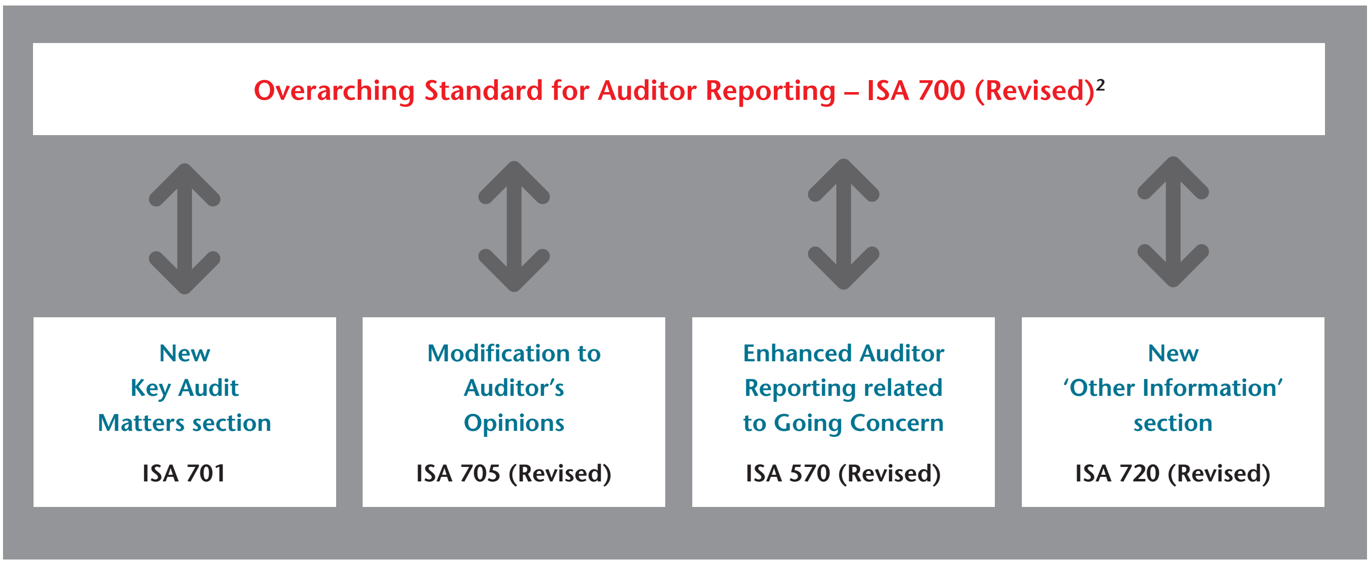
- Opinion section to be presented first;

- Enhanced auditor reporting on Going Concern (GC) *ISA 570 (Revised) Going Concern:*
  - Description of the respective responsibilities of management and the auditor for GC;
  - Separate section when a material uncertainty exists and is adequately disclosed; and
  - New requirement to challenge adequacy of disclosures for 'close calls' in view of applicable financial reporting framework.

- Affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities; and

- Enhance description of the responsibilities of the auditor and key features of an audit.

The focus for the breakfast briefing and this document is the communication of KAM in accordance with ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report.*



What are Key Audit Matters (KAM)?

KAM are defined as those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. They are selected from matters communicated with those charged with governance:

- Areas with increased risk requiring extra attention in the audit;
- Areas of auditor judgement relating to management judgements; and
- Significant events or transactions that have impacted the audit.

What needs to be included in the description of KAM?

- Why the matter was considered to be a KAM;
- How the matter was addressed in the audit; and
- Reference to the related disclosure(s), if any.

The UK's FRC, responsible for audit regulation in the UK, introduced similar standards in 2013, so a number of listed entities are now into their third year of adopting these. Although the UK standards are slightly different with additional disclosures required in relation to planning materiality and the scoping of the audit, in practice, the overall aim is consistent. As such, the end result of applying the UK standards is likely to be largely consistent if one was applying the ISA. Consequently, these UK entities can be viewed as 'early adopters' and lessons can be learned by other jurisdictions adopting extended audit reports for the first time.

In terms of the DFSA's oversight, Bryan Stirewalt commented that, 'as a unified regulator, we have a unique perspective in that we see audit reports from a wide range of legal entities and business models. The DFSA approaches regulation and supervision in a manner that is similar to the UK, so we will be taking a close look at what the FRC has said and will use that as a key benchmark going forward. We certainly will look closely at how the audit report enhances a company's governance and improves market behaviours.'

> 'The extended audit report is the foundation of future global audit reporting

Moderator guided discussion

Why introduce extended audit reports?

After a number of years of debate and following the global financial crisis of 2008, questions arose about whether the binary pass/fail audit report remained fit for purpose and what could be done to indicate more clearly to investors the value of the audit. Properly performed audits and audit reports currently give little indication of where auditors spend their time which led to questions about how the value of the audit report could be enhanced.

Complex and subjective areas have been discussed between auditors and Audit Committees for some time but this was not transparent to investors, or other users of the financial statements; the new extended audit report starts to address this. Risks of misstatement are identified and where these relate to complex areas and/or areas with subjective assumptions, the extended audit report explains the approach taken by the auditors to gain assurance. This enables users of the reports to identify quickly areas where the auditors had concerns and what the auditors did to resolve these concerns. It is worth noting that these areas are those that require judgement and/or are subjective and not necessarily the most material by size. The more common examples in UK entities include: the basis of accounting for revenue; pensions accounting; taxation; legal claims; impairment of intangibles; and loan loss provisions in financial institutions.

What are the experiences of the early adopters?

The FRC provided minimal guidance to UK auditors and entities to encourage audit firms to be innovative and insightful in their implementation of the new standards covering the extended audit reports. The FRC has reviewed a number of these new reports over the first two years of implementation and the Rolls-Royce extended audit report – which included non-mandatory findings – has been identified as a leading example of innovative development of the audit report.

Richard Ackland, KPMG engagement partner on the Rolls-Royce audit, commented that 'the new standard generally requires auditors to explain which stones they are overturning, why they are overturning them and what audit work was undertaken.' However, the new standard does not require auditors to say what the audit work revealed. In order to provide a more meaningful graduated scale – rather than a more traditional binary pass/fail result – KPMG applied some qualitative factors to their assessment of management's estimates and assumptions, with Richard noting that 'for Rolls-Royce we introduced a scale: Cautious, Mildly Cautious, Balanced, Mildly Optimistic and Optimistic with anything outside of the range constituting an audit difference.' Disclosures associated with KAM were also deemed to be ample, less than ample or more than ample.

The FRC has conducted reviews of the implementation of the extended audit reports in the UK and feedback from some investors is that while they are very happy with the new regime, they would like to see even more granularity in audit reports. Investors value reports that avoid the use of 'boilerplate' language and provide information about the specific outcomes of the audit work, audit findings, as well as the mandatory descriptions of the audit process.

ISA 701 requires the description of KAM to be tailored to the facts and circumstances of the individual audit engagement and the entity in order to provide relevant and meaningful information to users. IAASB guidance on the communication of KAM explains that:

- it is not intended to imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements; and
- it is not intended to represent or imply discrete opinions on separate elements of the financial statements (a 'piecemeal' opinion).

What benefits can be expected?

The benefits seen so far are:

- Enhanced value to users;
- More interaction between the Audit Committee, management and auditors regarding the audit approach;
- More attention by management to KAM given the enhanced public disclosure;
- Increase in professional skepticism as the audit work undertaken is described with greater granularity; and
- Enhanced users' perception of the value of audit.

The implementation of extended audit reports has made it clearer to management throughout the process that they are responsible for the financial statements and auditors are responsible for the audit.

Under current reporting requirements, some CFOs can find it difficult to get their Board to address fully matters which under the new standard might be classified as KAM, due to the desire for an unqualified audit report. The extended audit report brings such matters to the forefront so that they are addressed. Umar Saleem commented that 'As a CFO, this is welcomed.'

Extended audit reports make more information available to investors. A study[3] looking at trading activity patterns for entities where extended audit reports have been implemented found that 'companies with a low analyst coverage are associated with a significant increase in abnormal trading volume. In other words, as the information environment weakens (i.e. analyst following decreases) there is a greater increase in the usefulness of the reports as a result of the additional auditor and Audit Committee disclosures.'

'Enhanced users' perception of the value of audit

What challenges are likely to be faced?

It can be difficult to identify the items that need to be included in the extended audit report; KAM are selected from matters that have been communicated to the Audit Committee, but not everything communicated to the Audit Committee is necessarily a KAM.

Richard Ackland noted that, 'It may be difficult and uncomfortable (for example, in cases such as bribery and corruption), but auditors must be prepared not to pull any punches and raise issues for discussion. My advice would be to get a draft of the new audit report in early so discussion can start early to move things forward. From the first to the final draft we would expect some changes particularly in relation to more difficult discussions or sensitive areas, e.g. where there is a legal requirement to limit information provided (i.e. fraud investigations). However, it is difficult for management to argue with what the audit firm identifies as KAM because it's where the auditors have focused their work and is substantiated by the work actually done and reported to the Audit Committee.' Naturally, the auditor has a responsibility to act with sensitivity and professionalism in reporting KAM.

In the region there is some concern over a perceived increase in exposure for the Audit Committee. It has been commented that in extremis this might also lead to difficulty in finding suitable members for an Audit Committee. People may become more reluctant to take on the responsibility, particularly if they believe that the auditor's reporting of KAM is too candid and reflects on the Audit Committee's performance if control weaknesses are identified. However, there is an overriding feeling that the new requirements will add a new dimension to auditor's reporting resulting in Audit Committees and auditors working constructively together for the benefit of investors.

What are the practical considerations?

The ISA requires that the extended audit reports are mandatory for listed entities; however, other entities could choose to adopt the standards voluntarily, particularly when the benefits previously noted are considered.

The audit report will no longer be a boilerplate binary opinion following the implementation of the new standards, typically increasing from around 1000–1500 words to 2500–5000 words. One would hope that the audit work undertaken by the audit team is unlikely to change significantly save for the more bespoke drafting required.

The FRC has conducted reviews where the new standards have been implemented following 2013 and 2014 year-ends and a significant piece of feedback from this is that some reports failed to link up the movement of KAM between years; investors are keen to see more links between KAM reported in different years and are encouraging auditors to explain the differences, thus providing improving granularity of reports.

> The audit report will no longer be a boilerplate binary opinion

Sources and further reading

[1] IAASB Report: AT A GLANCE January 2015 – New and Revised Auditor Reporting Standards and Related Conforming Amendments.

[2] IAASB Slide Presentation in Support of the IAASB's New and Revised Auditor Reporting Standards from International Federation of Accountants.

[3] Reid, Carcello, Li & Neal: July 2015 p.25 – Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom.

FRC Report: March 2015 Extended auditor's reports – A review of experience in the first year.

FRC Report: January 2016 Extended auditor's reports – A further review of experience.

Conclusion

Increased transparency of the extended reports goes a long way to alleviate investors' concerns about audit. Umar Saleem commented that 'most savvy investors will dig deeper and not just look at the pass or fail audit report without asking questions; they would arrange a meeting to get proper insights into the company's financial performance and future plans if they are a serious investor'. The extended audit report makes this a standard part of the annual report and provides greater focus for investors on what the auditors regard as a key audit matter.

The extended audit report is the foundation of future global audit reporting, with improved audit communication. Some informed market participants would argue it is essential for the continued relevance of audit. For audit opinions to be valued investors want more information. Similar changes are taking place throughout the world: Australia will soon adopt its own version of the new ISAs; Canada is consulting on implementing new auditor reporting standards based on ISAs; and the USA is likely to have something similar within five years, with the proposals expected to be similar to UK standards and IAASB ISAs.

Edward Quinlan added, 'Audit Committees are not the primary beneficiary of extended audit reports. The main beneficiaries are the investors, regulators and auditors. The new audit report will serve to be another mechanism by which the quality of the audit can be judged.'

Based on UK experience, the regulator will use as an example the company that does the most and encourage others to emulate it. The audit profession and companies can use this as an opportunity to demonstrate the strength of their confidence in their own corporate governance structures by doing more than the bare minimum. Companies and auditors should see extended audit reporting as an opportunity to enhance their respective reputations.

The DFSA is the independent regulator of financial services conducted in or from the DIFC, a purpose-built financial free zone in Dubai, UAE.

The DFSA's regulatory mandate includes asset management, banking and credit services, securities, collective investment funds, custody and trust services, commodities futures trading, Islamic finance, insurance, an international equities exchange, and an international commodities derivatives exchange. In addition to regulating financial and ancillary services, the DFSA is responsible for supervising and enforcing anti-money laundering (AML) and counter-terrorist financing (CTF) requirements applicable in the DIFC. The DFSA has also accepted a delegation of powers from the DIFC Registrar of Companies (RoC) to investigate the affairs of DIFC companies and partnerships where a material breach of DIFC Companies Law is suspected and to pursue enforcement remedies available to the Registrar.

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