Audit Committee Alert
05/2015

The New Auditor's Report

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The assessment of the financial crisis in so far as corporate failures and the value of an audit are concerned, resulted in regulators and investors recognising that auditors have significant insight into the audited entity. However, the Auditor's Report is written in standardised boiler-plate language which does not provide any of that insight into this auditor knowledge of the entity other than a binary pass/fail opinion.

The IAASB's project was therefore specifically scoped to enhance auditor reporting within the existing scope of the audit – thus the auditor's work effort will not be expanded. It was merely an attempt to report on work that already performed by auditors, thus enhancing the communicative value of the Auditor's Report.

In this Alert, Nkonki brings to your attention information on the New Auditor's Report, which is effective for audits of financial statements for periods ending on or after 15 December 2016. This will bring about significant changes, particularly given that the Auditor's Report of listed entities will need to include a section on Key Audit Matters (KAM).

Nkonki summarises the key changes and the benefits envisioned by the New Auditor's Report to provide you more insight as an Audit Committee member.

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About Nkonki

Established in 1993, Nkonki, which is 100% Black-owned and 51% Black female-owned, has over 40 partners and registered auditors and more than 400 professional staff members, with offices in Gauteng, the Western Cape, KwaZulu-Natal and the North West. A member firm of Kreston International, Nkonki has access to deep global expertise in addition to its local knowledge through more than 20 000 professionals spread across 100 countries.

Nkonki is registered with the IRBA, and is accredited by the JSE to audit JSE-listed companies. The firm is fully equipped with an in-house accredited IFRS advisor, a Technical department to support assurance services, and an in-house Learning Centre to empower professional staff to excel in technical knowledge and service delivery.

Nkonki provides thought leadership on a number of pertinent issues through its Annual Audit Committee Conference for Retirement Funds (3 August), for the Public Sector (30 September) and for Listed Companies (12 October), Annual Integrated Reporting Awards for the Top 100 JSE Listed Companies and for the Schedule 2 State Owned Companies.

The firm is also partnered with the Institute of Directors to train Audit Committee members on Audit Committee Effectiveness using the ACE Model – Winning Formula for Audit Committees, a book authored by Nkonki CEO, Sindi Zilwa.

In 2004 Nkonki was awarded the Top Emerging Female Owned Company of the Year, and in 2013 Nkonki's CEO was awarded the Overall Professional of the Year due to the professional integrity applied by the firm in formulating audit opinions.

Our Vision:

To be a globally respected assurance and advisory services firm through ingenuity, efficacy, and holistic knowledge.

Our Mission:

To be a resourceful trusted brand, that consistently partners with clients, to ingeniously enhance their ability to continuously achieve their business aspirations.

New Auditor's Report

Essentially, it prepares the foundation for the future of global auditor reporting and improved auditor communication and is therefore critical to the continued relevance of the audit profession globally.

The changes also acknowledge that whilst the audit opinion is valued, it could be more informative – users are demanding more relevant and decision-useful information about entities and the financial statement audit.

Key changes

There are two key areas of change which cover reporting on Key Audit Matters and on Going Concern, both explained below.

Key Audit Matters (KAM)

In future, effective for audits of financial statements for periods ending on or after 15 December 2016, the Auditor's Report of listed entities will include a section on KAM. A new auditing standard, ISA 701, has been issued to give effect to this.

KAM is 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.

In determining KAM, the auditor will consider the areas of higher assessed risk of material misstatement; areas that require significant auditor and management judgement (for instance where accounting estimates are used); as well as the effect of significant events or transactions that occurred during the year on the audit.

This risk of the auditor being the originator of information via KAM was a concern initially raised by preparers of financial statements. A consequential benefit of the KAM requirement might in future be that as management know that KAM will be reported, a reluctant preparer might be encouraged to consider and improve the transparency of the entity's financial information.

Initially KAM is only a requirement for listed entities. However, any auditor can elect to disclose KAM, but would obviously in the planning stages of the audit discuss that with the audit committee.

What are KAM's?

KAM's are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

Are KAM's always communicated in the Auditor's Report?

- The auditor is required to include each KAM unless
  - Law or regulation precludes disclosure
  - In extremely rare circumstances, the auditor determines that the matter should not be communicated
- Adverse consequences of communicating the KAM would reasonably be expected to outweigh the public interest benefits of such communication
- KAM is prohibited for a disclaimer of opinion, but required for a qualified or adverse opinion
- In certain limited circumstances, there may be no KAM's to be communicated

Which Auditor's Report will include a KAM section?

KAM is required to be communicated in the auditor's report for audits of financial statements of listed entities in accordance with new ISA 701

- Law or regulation may require KAM for audits of entities other than listed entities (e.g., "public interest entities", or public sector entities)
- Auditors may voluntarily, or at the request of management or audit committees, communicate KAM in the auditor's report for entities other than listed entities

What are the documentation requirements for KAM's?

In accordance with ISA 230, ISA 701 requires the auditor to document the professional judgments made about:

- Why a matter that required significant auditor attention is or is not a KAM
- Why a matter determined to be a KAM is not communicated

There is no requirement to document the rationale for why matters communicated to audit committees were not matters that required significant auditor attention

Going concern

As part of the changes to the auditing standards, the auditor will have to raise certain going concerns flags in the Auditor's Report in future. These are in the following instances:

- If management used the going concern basis of accounting inappropriately in preparing the financial statements, the auditor should express an adverse audit opinion.

- Also, if management did not adequately disclose information about material uncertainties, the auditor should express a qualified or adverse opinion and state the basis for the qualification that material uncertainties existed that may cast significant doubt on the entity's ability to continue as a going concern; and that the financial statements do not adequately disclose such matters.

- Where a material uncertainty exists, which has been adequately disclosed by the entity, the Auditor's Report must include a paragraph to this effect.

The changes require that, if management used the going concern basis of accounting inappropriately in preparing the financial statements, the auditor should express an adverse audit opinion.

It further requires that, if management did not adequately disclose information about a material uncertainty, the auditor should express a qualified or adverse opinion and state the basis for the qualification that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose such a matter.

What should be included in the description of a KAM?

- The description should always include:
  - Why the matter was considered to be a KAM
  - How the matter was addressed in the audit
  - Reference to the related disclosure(s), if any
- The description of how the matter was addressed in the audit may include:
  - Aspects of the auditor's response or approach
  - Brief overview of procedures performed
  - Indication of the outcome of the auditor's procedures
  - Key observations with respect to the matter

However, if management provided adequate disclosure about the material uncertainty, the auditor will give a clean opinion, but alert users to the material uncertainty disclosed by management. This will be done under a separate heading in the Auditor's Report to ensure that it is prominent.

It is important to note that the going concern requirements are not just applicable to the audit of listed entities, but to all audits performed in accordance with ISA.

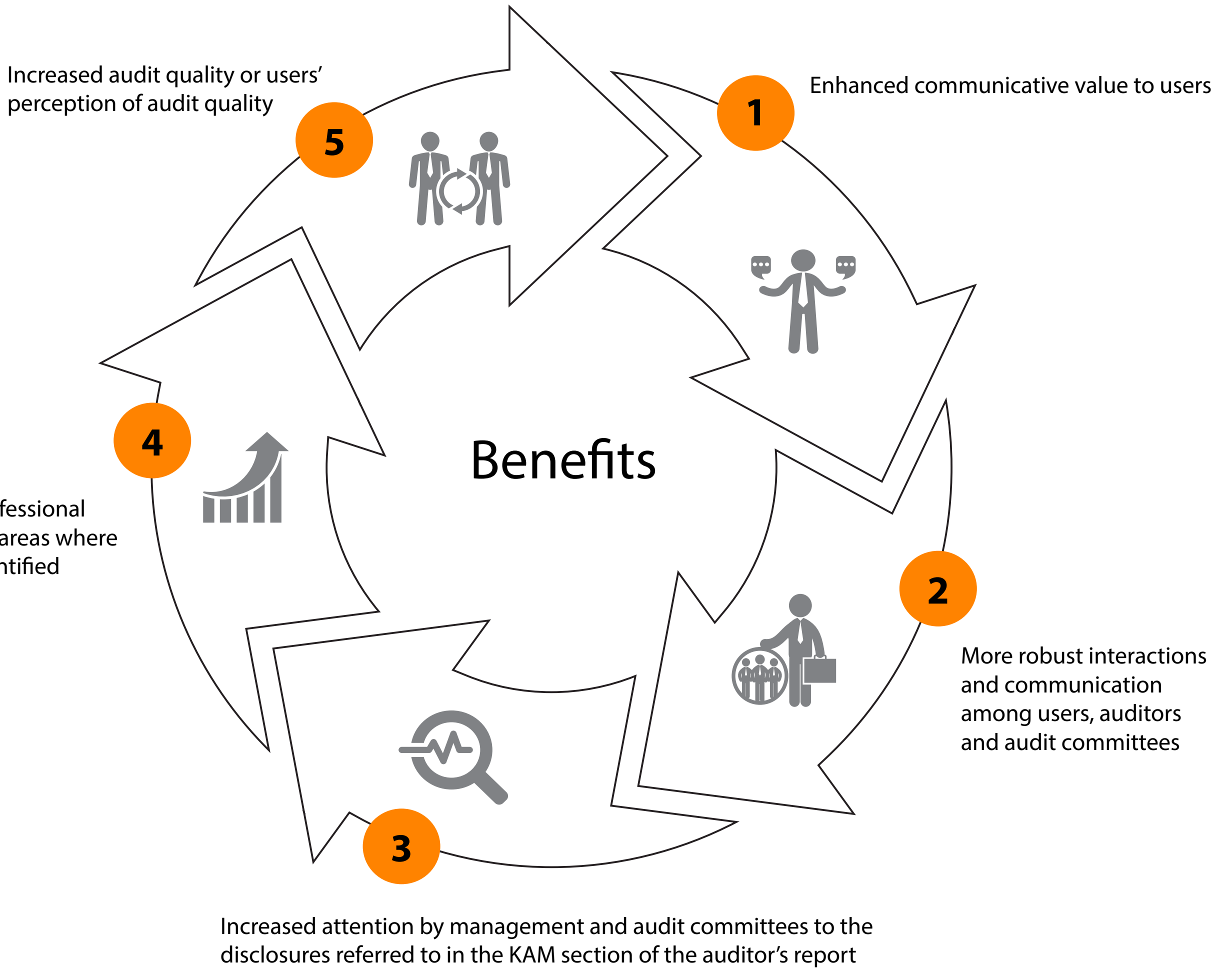
Considerations in describing KAM:

- KAM should be entity-specific and avoid standardized or overly technical language
- Description of a KAM should not
  - Imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements
  - Contain or imply discrete opinions on separate elements of the financial statements (a "piecemeal opinion")

Interaction between KAM and Going Concern

- Matters relating to Going Concern, including "close calls", may be determined to be KAM and communicated in the auditor's report in accordance with new ISA 701
- When a material uncertainty related to Going Concern exists, it is by nature a KAM, but is reported separately in the "Material Uncertainty Related to Going Concern" section of the auditor's report

Benefits of the changes



The most important intended benefit of the changes to the Auditor's Report is to enhance communication between auditors and investors, as well as audit committees.

In addition, it is envisaged that both auditor and entity behaviour will improve. Auditors will have a renewed focus on matters to be reported as key audit matters (KAM), which should increase their levels of professional scepticism.

On the other hand the preparers of financial statements would possibly give stronger attention to matters that auditors will be highlighting as KAM's in cross reference to financial statement disclosure, which will enhance the transparency of financial statements as a whole.

Other changes to the Auditor's Report:

Other minor changes to the report include the following:

- The auditor's opinion required to be presented first
- Required Basis for Opinion section for unmodified opinions
- Statement about independence and other ethical responsibilities
- Naming of the engagement partner (listed entities only)
- Enhanced description of auditor responsibilities and key features of the audit
- Required identification section when those charged with governance are separate from management

For more information please visit www.nkonki.com

Contact Details

Physical Address:

Nkonki House
1 Simba Road cnr. Nanyuki Road
Sunninghill Johannesburg, 2157

Postal Address:

P.O. Box 1503 Saxonwold 2132

Contact person:

Thebe Matubatuba

Thebem@nkonki.com

Tel: +2711 517 3000   Fax: +2711 807 8630

www.nkonki.com

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