OVERVIEW OF THE NEW AUDITOR'S AUDIT REPORT UNDER THE ISAs

Mazars Fact sheet – February 2016

INTRODUCTION

The auditor's report is the final output of the audit process. Many users of the financial statements and stakeholders have called to have a more informative and relevant auditor's report. There has been increasing criticism over standardised wording and a request for audit reports to be more transparent and tailored to individual clients.

These queries have been taken into account by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) and a revised set of auditing standards on auditors' reports were issued in 2015. These are effective for companies with financial years ending on or after 15 December 2016.

It is granted that the national laws and requirements should never be by-passed if they are more restrictive than the International Standards on Auditing (ISAs) / European (EU) Directive. Each European country may add local requirements during the transposition of the Directive.

The scope of these new standards is set out in section 1 below.

This factsheet aims at explaining the main impacts of the changes decided by the IFAC, and helping the anticipation of their application, that impacts both our clients and us as auditors.

SUMMARY

I. MAIN CHANGES IN THE NEW AUDITOR'S REPORT

Highlight of the key new features

APPLICABLE FOR AUDIT REPORT OF LISTED ENTITIES AND NON-LISTED ENTITIES

- Revised description of management and auditors' responsibilities, both including going concern assessment and other topics
- New order for the sections of the report, the opinion section being the first information to be presented in the report
- New statement that the auditor is independent of the entity and has fulfilled the auditor's other ethical responsibilities.

APPLICABLE FOR AUDIT REPORT OF LISTED ENTITIES

- Adding of a paragraph on why the matter was considered to be a Key Audit Matter; how the matter was addressed in the audit; and reference to the related disclosure(s)*
- Disclosure of the name of the audit partner

* May also be applicable in circumstances when the auditor otherwise decides to communicate Key Audit Matters in the auditor's report.

Main impact on the auditor's report in terms of time spent on the drafting of the report for listed companies

One of the new features of the revised set of auditing standards is the auditor's responsibility to communicate Key Audit Matters in the auditor's report and this topic is dealt with in a new ISA: ISA 701.

This new obligation is detailed in the next Chapter (Chapter II. Focus on the Key Audit Matters).

Focus on **going concern**

We will now be required to add additional information dealing with going concern in the audit report:

- *Always:*
  - ➔ Description of the responsibilities of management and the auditor on the topic of going concern in the sections on responsibilities of management and Auditors' responsibilities;
    - Management's responsibility for assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.
    - Auditor's responsibility to conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- *When the auditor has identified matters related to going concern, including "close calls" (=If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists):*
  - ➔ The auditor may determine those matters to be Key Audit Matters and therefore include them in the Key Audit Matters section in the audit report (See Chapter II. Focus on the Key Audit Matters).
- *When a material uncertainty exists and is adequately disclosed:*
  - ➔ Additional separate section under the heading "Material Uncertainty Related to Going Concern" (It is by nature a Key Audit Matter, but it is reported separately in a "Material Uncertainty Related to Going Concern") area of the audit report.

II. FOCUS ON KEY AUDIT MATTERS

ISA 701 on Key Audit Matters applies to audits of listed entities and in circumstances when the auditor otherwise decides to communicate Key Audit Matters in the auditor's report.

What is the **definition** of a key audit matter?

Key Audit Matters are "those matters that, in the auditor's professional judgment, 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." (ISA 701 §8)

What is the **purpose** of the adding of a Key Audit Matters section in the auditor's report?

"The purpose of communicating Key Audit Matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.

Communicating Key Audit Matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

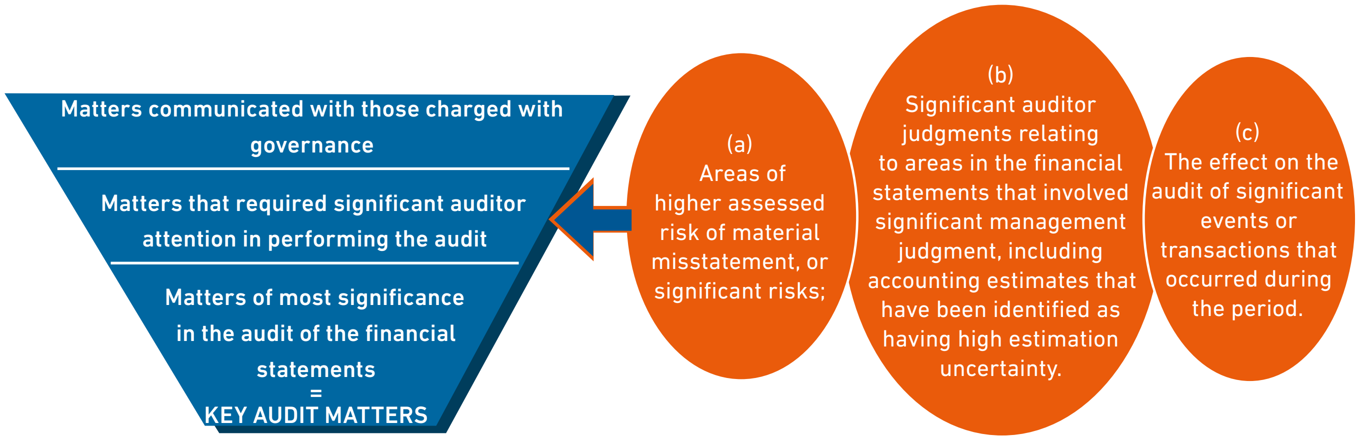
This communication may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements." (ISA 701 §2)

How does the auditor **determine** the Key Audit Matters?

"The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- (a) Areas of higher assessed risk of material misstatement, or significant risks;
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (c) The effect on the audit of significant events or transactions that occurred during the period." *(ISA 701 §9)*

"The auditor shall determine which of the matters determined in accordance with paragraph 9 were of most significance in the audit of the financial statements of the current period and therefore are the Key Audit Matters." (ISA 701 §10)



What is to be done by the auditor for the Key Audit Matters section in the auditor's report?

The audit report must include:

- Why the matter was considered to be a Key Audit Matter;
- How the matter was addressed in the audit;
- Reference to the related disclosure(s).

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.

III. WHAT DOES A NEW AUDITOR'S REPORT **LOOK LIKE?**

Structure of the auditor's report and related ISAs

Section	Compulsory?	Related ISA
Opinion	Yes	ISA 700, 705
Basis for Opinion	Yes	ISA 700, 705
Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"	Yes	ISA 720
Emphasis of Matter	If necessary	ISA 706
Material Uncertainty Related to Going Concern	If necessary	ISA 570
Key Audit Matters	Yes for listed companies	ISA 701
Other Matter	If necessary	ISA 706
Responsibilities of Management and TCWG for the Financial Statements *(including going concern)*	Yes	ISA 700
Auditor's Responsibilities for the Audit of Financial Statements *(including going concern)*	Yes	ISA 700
Report on Legal and Other Regulatory Requirements	If applicable under local law / regulation / national auditing standards	ISA 700

Models of auditor's reports in the ISAs

ISA 700 (Forming an opinion and reporting on financial statements) gives 4 illustrations of auditor's reports on financial statements:

- 1. An auditor's report on financial statements of a listed entity prepared in accordance with a fair presentation framework
- 2. An auditor's report on consolidated financial statements of a listed entity prepared in accordance with a fair presentation framework
- 3. An auditor's report on financial statements of an entity other than a listed entity prepared in accordance with a fair presentation framework (where reference is made to material that is located on a website of an appropriate authority)
- 4. An auditor's report on financial statements of an entity other than a listed entity prepared in accordance with a general purpose compliance framework

ISA 570 (Going concern) gives 3 Illustrations of auditor's reports relating to going concern

- 1. An auditor's report containing an unmodified opinion when the auditor has concluded that a material uncertainty exists and disclosure in the financial statements is adequate.
- 2. An auditor's report containing a qualified opinion when the auditor has concluded that a material uncertainty exists and that the financial statements are materially misstated due to inadequate disclosure.
- 3. An auditor's report containing an adverse opinion when the auditor has concluded that a material uncertainty exists and the financial statements omit the required disclosures relating to a material uncertainty.

ISA 720 (The auditor's responsibilities relating to other information and related conforming amendments) gives 7 more illustrations of auditor's reports.

You will find the text of the above mentioned illustrations in the "New and revised standards not yet effective" section of the 2015 IFAC handbook, available on:

https://www.ifac.org/publications-resources/2015-handbook-international-quality-control-auditing-review-other-assurance

NEW AND REVISED STANDARDS NOT YET EFFECTIVE

- ISA 260 (Revised) Communication with those charged with governance
- ISA 570 (Revised) Going concern
- ISA 700 Forming an opinion and reporting on financial statements
- ISA 701 Communicating Key Audit Matters in the Independent auditor's report
- ISA 705 (Revised) Modifications to the opinion in the independent auditor's report
- ISA 706 (Revised) Emphasis of Matter paragraphs and other matter paragraphs in the auditor's report
- ISA 720 (Revised) The auditor's responsibilities relating to other information Conforming amendments to other ISAs

Experience of the new auditor's report **in the UK**

The UK has anticipated the changes embedded in the new auditor's report and adopted a new standard on the auditor's report in 2013. The reading of the 2014 audit reports of UK listed entities (especially FTSE 100 companies) gives an insight of what is expected in terms of communication in the new auditor's report according for 2016 audit reports.

Note that the UK regulation goes even beyond the obligations of the ISAs: for example, the UK auditors have communicated in their auditor's report on materiality and scoping considerations for group audits, which is not required by the ISAs.

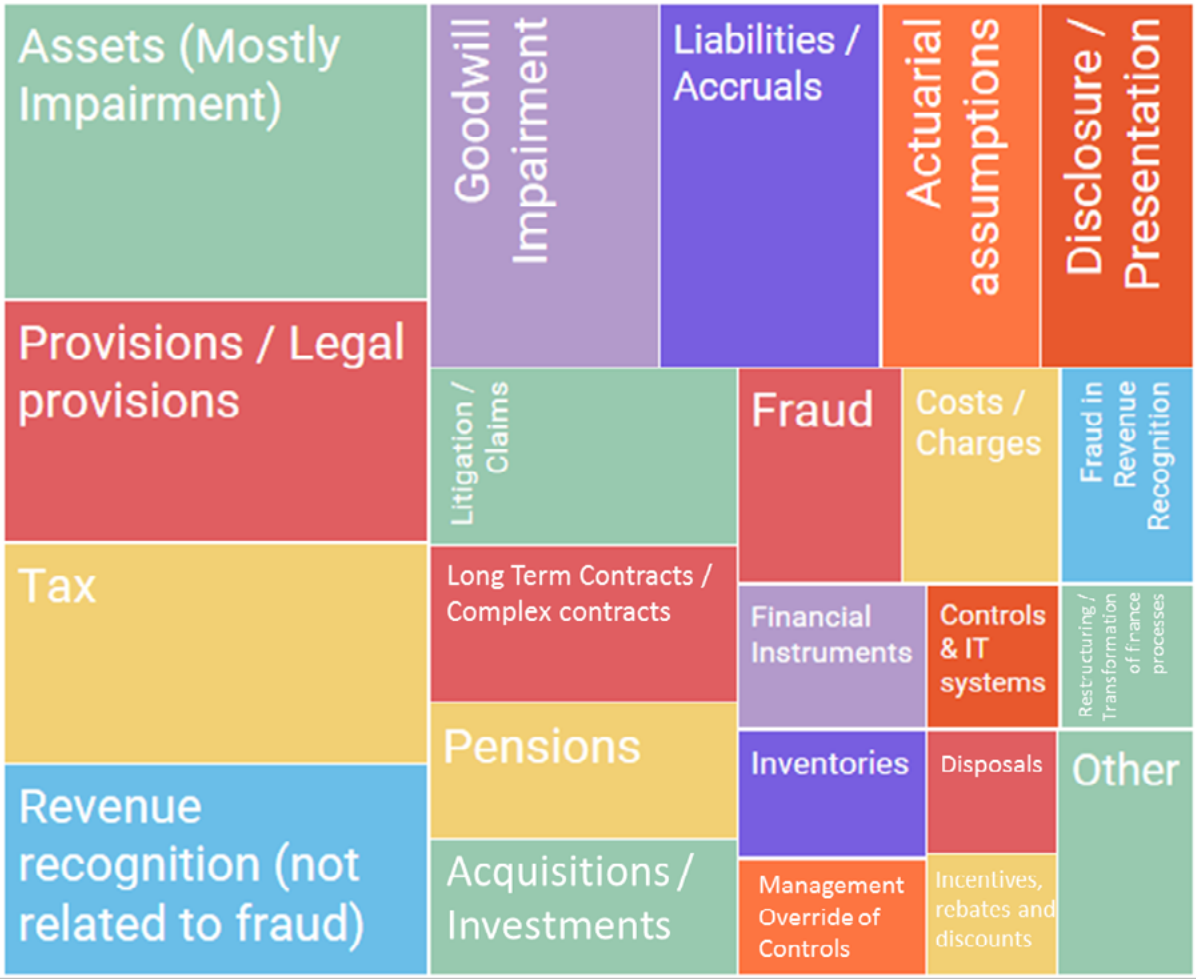
Examples of Key Audit Matters

Between July and September 2014 the FRC (Financial Reporting Council) carried out a detailed analysis of 153 UK extended auditor's reports (63 of which were of FTSE 100 companies) that had been published at that time. The main 3 Key Audit Matters reported in the sample relate to the following topics:

- Impairment of assets
- Tax
- Goodwill impairment.

Mazars also carried on a study on the Key Audit Matters embedded in the auditor's report (2014 and 2014/2015 reports) for 2014 FSTE 100 companies in the UK, covering different sector industries.

The Key Audit Matters deal with the following topics (size of the box proportional to the number of occurrence of the topic):



Note that some of the auditor's reports include a follow-up of the perimeter of the Key Audit Matters and explain the reason for deleted Key Audit Matters and new Key Audit Matters compared to the previous year.

IV. IMPACTS ON MANAGEMENT AND THOSE CHARGED WITH GOVERNANCE

We have noted below some points management / those charged with governance could consider in order to assess the impact of the new auditor's reports:

01. What matters could be Key Audit Matters in the auditor's report?
02. Are the Key Audit Matters in the risk mapping / cartography of the entity? If not, why? Is there a need for the entity to update its own risk assessment?
03. How the Key Audit Matters are addressed by the entity and is there an adequate action plan?
04. Is the process for evaluating the entity's ability to continue as a going concern appropriate and are there sufficient controls?
05. Are the disclosures of the financial statements sufficient and appropriate to give relevant information on the Key Audit Matters and Going concern especially in case of close-calls?
06. What is the process of producing and controlling the "other information" made available to the different stakeholders and the auditor? Is the timetable appropriate? Are there areas that could be anticipated in the audit process?
07. Is there someone in charge of checking the consistency of the "other information" / "management report" with the "financial statements"? When?
08. Timetable and frequency of the audit committee meetings: are there enough meetings and in the right timing so as to anticipate the new auditor reporting requirements and process?
09. When will a draft of the new auditor's report be ready so that management / those charged with governance have time to review and challenge it? Did you ask your auditor to share with you what could the future auditor's report of your entity would look like?
10. Do certain potential Key Audit Matters result from poor controls or processes and can these be addressed? What is the impact of the disclosure of these matters on the opinions of investors and other stakeholders?

Focus on the need for anticipation for Key Audit Matters and going concern

The idea is that for anticipation smooth transition, the auditors and the client should begin to discuss the content of the Key Audit Matters section of the auditor's reports on the 2016 financial statements now.

Key Audit Matters are likely to highlight sensitive topics involving management judgments and estimates, and in that context, it is important that management continue providing the auditor with sufficient and documented details on the key assumptions, sensitivity analysis, uncertainties, etc.

Those charged with governance / audit committees may require more information from management on the topics dealt with in the Key Audit Matters section of the auditor's report.

Finally, since "going concern" will be highlighted in the new auditor's report, it is key that management of the audited entities perform a formal assessment of the appropriateness of the going-concern assumption, even when no clear indicators of material uncertainty exist.

V. ADDITIONAL REQUIREMENTS FOR EUROPEAN COUNTRIES

The European Union adopted its new auditor reporting requirements as part of the recent audit reform legislation. The legislation will be effective for 30 June 2017 fiscal year-end audits. The EU approach is in line with the IAASB's but contains some requirements that go beyond the ISA requirements.

The new European audit legislation comprises updated European Union (EU) provisions regarding the communication of the auditor in:

- The Directive2014/56/EU amending Directive 2006/43/EC on statutory audits (2006 SAD) and containing a series of amended and new requirements governing every statutory audit in the EU; and
- The Regulation (EU) No 537/2014 containing additional requirements that relate specifically to statutory audits of PIEs in addition to the ones stated in the Directive.

The additional requirements for European countries are listed below:

- → The auditor's report must include a statement that no prohibited non-audit services were provided;
- → The Key Audit Matters ("(i)description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud + (ii) a summary of the auditor's response to those risks + (iii) where relevant, key observations arising with respect to those risks.") are to be described for Public interest entities (PIE) which are:
  - companies with securities admitted to trading on a regulated market in Europe;
  - private credit institutions and insurance undertakings; and
  - entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

- → The auditor must confirm in his/her report that the audit opinion is consistent with the additional report to the audit committee ("Statutory auditors or audit firms carrying out statutory audits of public-interest entities shall submit an additional report to the audit committee of the audited entity." (Article 11 of Regulation (EU) No 537/2014)

  Note that the EU requirements regarding communication with the audit committee are much more specific than the ones included in ISA 260. This topic is not dealt with in this guidance fact sheet.

The disclosure of the name of the engagement partner was already required in the European Union before the issuance of the new auditor reporting requirements (Directive 2006/43/EC - 17 May 2006).

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