

Key audit matters: unlocking the secrets of the audit

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About this report

This report reviews the first-year implementation of the IAASB's revised auditor reporting standards. It finds that these standards not only provide better information for investors, but also encourage improvements throughout the financial reporting chain.

Foreword



The IAASB's 2015 changes to the auditor reporting standards became applicable in many parts of the world from the December 2016 year-end audits.

The most obvious change is the introduction of 'key audit matters', in which the auditor lists the areas of the audit that involve the most risk – and therefore require the most judgement – and explains the audit approach to those areas. In addition, the revised standards reorder the audit report to put upfront the information that's most relevant to users. And there are also improvements in highlighting going concern issues, with a requirement to disclose 'close calls' on going concern and the use of a clearly-identified separate section where there is a material uncertainty related to going concern.

ACCA's report looks across the implementation of these new standards in eleven countries across four different continents. This report draws upon a detailed analysis of 560 new-style audit reports and feedback from roundtables, at which different stakeholders gave their perspectives on the new reports. This report was also discussed at the ACCA

Global Forum for Audit and Assurance, which comprises nearly twenty members from different countries across the globe. In addition, ACCA collaborated with local professional bodies, regulators and stakeholders in Singapore and Malaysia to produce two reports on the impact of key audit matters in those countries. Links to those reports can be found in the references.

In Malaysia, we are now entering our second year of reporting and the audit regulator has completed its inspection of firms' first-year audits under the new standards. There are market demands for more expansive disclosures in the audit report and for auditors to provide findings in respect of each of the key audit matters, even though this could be misinterpreted as giving a separate opinion on the issues disclosed. Yet further innovations in the audit report are certainly possible, if audit regulators can avoid inadvertently encouraging

defensive disclosures from auditors and can encourage firms to aim for innovative and high quality disclosures. In this way, the full benefits of the new audit reports can be realised. The key finding of ACCA's report is that the benefits of key audit matters go beyond better information for investors, to encompass improved governance, better audit quality and enhanced corporate reporting.

The publication of this report is timely at the time of intense debate about the structure and governance of the standard-setter. It demonstrates the innovation and foresight that public interest standard-setting can bring to audit and the value that audit can bring to the financial reporting ecosystem.

Dato' Lock Peng Kuan
Chairman, ACCA Global Forum
for Audit and Assurance Partner
and Co-Leader Audit & Assurance,
Baker Tilly Malaysia

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Executive summary

Key audit matters (KAM) were developed by the International Auditing and Assurance Standards Board (IAASB) to respond to the challenge from stakeholders to improve the transparency and clarity of audit reports. A revised suite of auditor reporting standards were issued in 2015 with an effective date of December 2016.

Some countries, including the UK and the Netherlands, decided to adopt the new standards before December 2016 in order to realise the benefits earlier. And a small number of countries have delayed implementation, to allow more time for implementation. The US Public Company Accounting Oversight Board has issued its own proposals that address many of the same issues as the IAASB's standards.

ACCA's research applies both quantitative and qualitative analysis to assess the first year adoption of new auditor reporting standards in Brazil, Cyprus, Greece, Romania, Kenya, Nigeria, Oman, Romania, South Africa, the UAE, and Zimbabwe. The quantitative analysis included obtaining and analysing over 560 audit reports.

The qualitative analysis included holding roundtables with auditors, preparers, audit committee members, investors and regulators to listen to their perspectives on the experience of reporting KAM for the first time or, in the case of those countries yet to adopt, their preparation for adoption.

In addition to being useful for investors, ACCA's work identified three other benefits of KAM:

- Disclosure of KAM stimulates better governance.
- Disclosure of KAM supports better audit quality.
- Disclosure of KAM encourages better corporate reporting.

As these three benefits are significant contributors to better financial reporting more generally, it is important that audit firms are given encouragement to improve their implementation of the standard, through proportionate and sensible regulation. ACCA's report also identifies some areas for potential improvement in future years.

The report highlights some examples of good practice.



1. Introduction and background

For many years, investors have been saying they want audit reports to give more detail about the audit process. They were of the view that more contextual information about the audit would help investors differentiate better between companies that had received ‘clean’ audit reports.

As a result, the concept of ‘key audit matters’ (KAMs) was created. This requires the auditor to set out in a separately identified section of the audit report ‘those matters that, in the auditor’s professional judgement, were of most significance in the audit of the financial statements of the current period... selected from matters communicated with those charged with governance’. This requirement, mandatory for listed companies only, was included within the new ISA 701.

Further changes to the audit report were included for all auditors, including reordering of the sections of the audit report so that the opinion comes first, and improved requirements for explaining what work the auditor has done in respect of going concern, ‘near misses’ in relation to going concern and the ‘emphasis of matter’ section of the report.

These innovations were adopted early in some countries, such as the UK and the Netherlands, but in others they were adopted for the first time in audits with a December 2016 year-end. It is therefore timely to investigate the implementations of the new audit report standards in these countries and contrast them with the experience of the UK.

The methodology employed by the UK Financial Reporting Council in undertaking their post-implementation reviews has been adopted as far as possible, in order to provide some comparability with those reviews. Approximately 560 audit reports were obtained and categorised and this data was used to generate the quantitative findings in this report.

These quantitative findings were supplemented by a series of roundtables in Cyprus, Greece, Abu Dhabi, Oman and Romania, at which auditors, audit committee members, preparers and academics discussed the impact of the new audit report standards. Their comments have been incorporated into this report.

In addition, this report refers to the reports produced by ACCA, ACRA, ICPAS and NTU in Singapore (ACCA et al. 2017) and by ACCA, AOB and MIA in Malaysia (ACCA et al. 2018). The quantitative data does not incorporate statistics from these countries.



2. Improvements to the reporting supply chain

Key audit matters make significant improvements to the financial reporting supply chain.

The principal justification for key audit matters (KAMs) was that including a section on these would produce useful information for investors (IAASB 2011: para 23). This objective has been achieved, with the findings of this report confirming findings from previous work that shows that the information is considered useful by investors (FRC 2015: page 57).

In addition, ACCA's outreach shows that highlighting KAMs has given rise to a number of other benefits that may potentially be even more valuable.

2.1 BENEFITS FOR GOOD GOVERNANCE

Publication of KAMs has provided new focus for discussions between the auditor and the audit committee. For the first time, there is transparency in the most important audit issues that were discussed between the audit engagement partner and the audit committee. As a result, feedback from audit committee members shows that disclosure of KAMs has resulted in improvements in corporate governance.

Feedback from the roundtables indicates that it was previously established best practice for management, the audit committee and the auditor to focus on similar risks of material misstatement.

Accordingly, KAMs merely reflected what should already have been in place at the best companies. Therefore, KAMs may have a positive impact on companies where governance can be improved.

For example, in Cyprus, roundtable participants suggested that they would find it unusual for the auditor to inform the audit committee about issues of which the audit committee was not already aware. Management would be expected to inform the audit committee about every salient matter. The added focus in the auditor and audit committee's discussion of important issues was expected to make this process work more effectively.

□ *'Issues that cause concerns to the management of the company under audit should definitely be KAMs'.*
Auditor, Greece

Additionally, the market view in Romania is that the introduction of KAMs will enhance the role of the audit committee within the next few years of its application. In particular, the importance of having the committee members with recent and relevant financial experience was also highlighted, as their role is pivotal when discussing KAMs.

2.2 BENEFITS FOR THE AUDIT PROCESS

The process of reporting outputs from the auditor's reporting to the audit committee appears to have had a positive impact on audit quality. There is, so far, no evidence of that KAMs are being used defensively to reduce the auditor's liability. Indeed, some of the exceptional reporting identified in Chapter 5 comes from audit teams who are prepared to consider complex matters requiring careful judgement and to explain their audit approach to these matters publicly in their audit reports.

□ *'Auditors will put their professional scepticism more in order'.*
Investor, Romania

Feedback from the roundtables was more mixed. One auditor told us that he 'did not believe that the auditor's work is enhanced because of KAMs' and that he was concerned that the new auditor's report might end up 'carefully drafted from a legal point of view'. It may be, however, that some auditors argue that KAMs have only a limited impact on audit quality because they believe their audit quality to be already high.

ACCA believes that these three benefits – better corporate governance, better auditing and better financial reporting – will be the true legacy of KAMs.

Other auditors suggested that KAMs would have a positive impact on quality, noting that once a matter has been selected as a KAM, audit supervisors will expect to see a commensurate response in the audit file. As well as getting auditors to focus appropriately on issues that are KAMs, it may also encourage auditors to – appropriately – do less work on lesser issues that are not KAMs. This could allow auditors to spend more time on the bigger issues.

‘It gives stakeholders a sense of where an auditor put most of their effort, and it is extremely important for investors to understand them and then question as well’.
Roundtable participant, UAE

Another auditor reflected that disclosing matters within KAMs gave these issues much more emphasis than in the past. As a result, it was inevitable that auditors would become more sceptical.

2.3 BENEFITS FOR FINANCIAL REPORTING

There is evidence (in ACCA et al. 2017) that reporting by the auditor in relation to part of the financial statements has, in some cases, led companies to add to the disclosures in the financial statements made in previous years. In this way, KAMs have catalysed better financial reporting.

While this outcome was anticipated in the application material to ISA 701, it is significant to detect tangible improvements in financial reporting as a result of the audit process (ISA 701.A37).

A37. Management or those charged with governance may decide to include new or enhanced disclosures in the financial statements or elsewhere in the annual report relating to a key audit matter in light of the fact that the matter will be communicated in the auditor’s report. Such new or enhanced disclosures, for example, may be included to provide more robust information about the sensitivity of key assumptions used in accounting estimates or the entity’s rationale for a particular accounting practice or policy when acceptable alternatives exist under the applicable financial reporting framework.

ACCA believes that these three benefits – better corporate governance, better auditing and better financial reporting – will be the true legacy of KAMs. Hence, it is important that auditors are given the encouragement to continue to deepen their reporting of KAMs in audit reports.

In June 2017, the US Public Company Accounting Oversight Board (PCAOB) approved a new audit reporting standard for the US, which introduces disclosure of ‘critical audit matters’ and is largely

equivalent to the standards issued by the International Auditing and Assurance Standards Board (IAASB). There has been some opposition to the introduction of this US standard, particularly from business groups, which argue that it may be confusing for investors to have companies and auditors reporting on the same issues, using different language. There are also concerns that auditors will resort to defensive disclosures of audit matters and will use ‘boilerplate’ disclosures to mitigate risk.

‘These changes have helped bolster the credibility of the profession’.
Roundtable participant, Oman

While these concerns are reasonable, ACCA’s research and roundtable feedback did not indicate that either of them is actually happening. And while there was evidence of common innovations among audit firm networks, ACCA has not seen widespread sharing of standardised wording. While the US legal environment is distinct from that of other countries, ACCA nevertheless believes that there are grounds to be optimistic about how the publication of critical audit matters will affect the financial reporting supply chain.



3. Main findings and observations

3.1 SMART REGULATION IS NEEDED TO NURTURE INNOVATION

ACCA's work has identified examples of good practice, as well as some audit reports that had room for improvement. Some of the examples of good practice and interesting disclosures are provided in Chapter 5 below. It is important that regulators continue to encourage auditors so that the benefits of KAMs can be realised.

There is a risk that a regulatory approach that focuses on the precise requirements of auditing standards may lead auditors to approach KAMs as a compliance exercise rather than as an opportunity to communicate more effectively with audit committees and to stimulate better reporting.

The UK Financial Reporting Council (FRC) has led the way in this area. The FRC was the first standard-setter to introduce the new audit reporting standards, as it was an early adopter of the standards, in 2013, and included some additional requirements not in the IAASB standards, such as disclosure of audit materiality. In the first two years of implementation, the FRC issued two reports on the content of

audit reports, with a particular focus on KAMs. In these reports, it encouraged firms to learn from good reporting and benefit from the positive experience of best practice disclosures.

3.2 INTERACTIONS BETWEEN MATERIAL UNCERTAINTY, EMPHASIS OF MATTER AND KAMs ARE COMPLEX AND SUBJECT TO MISINTERPRETATION

'I think we are giving more information than necessary... we might even give the opportunity for someone to hide something'.
Academic, Cyprus

ACCA's work has found some varied practice in relation to the interactions between the concepts of material uncertainty on the grounds of going concern, emphasis of matter and KAMs. ACCA believes that the overriding objective should be the making of more transparent disclosures, and finds that that objective is very largely being achieved. Even so, it appears that auditors may not comprehensively understand the interactions between ISA 570, ISA 701 and ISA 706.

For example, ACCA made the following findings.

- 'Going concern' is occasionally listed as both a material uncertainty and a KAM. ISA 570 says that, in the event that a material uncertainty is determined, the issues that give rise to the material uncertainty may be a KAM. But 'going concern' should not be both a material uncertainty and a KAM.
- Some items are included as both an 'emphasis of matter' and a KAM. ISA 706 says that an item that has been selected as a KAM may not be considered for disclosure within an 'emphasis of matter' paragraph.

'Auditors are not trying to hide anything, and the fact that KAMs are now disclosed in audit reports makes more transparent the matters they had in mind in prior years as well'
Auditor, Cyprus

ACCA heard feedback from some roundtable participants that there was concern that KAMs 'might be used to bury emphasis of matter paragraphs' or to otherwise hide important information.

In the first year of implementation in the UK, most audit reports did include the risk of misstatement due to fraud in revenue recognition as a KAM.

While the intention of the IAASB is that KAMs should be afforded higher priority than emphasis of matter paragraphs, it is clear that the usefulness of information for users remains a high priority. Accordingly, ACCA encourages regulators to focus on the overall usefulness of information provided in the audit report rather than the detailed requirements of specific standards.

Alongside this, ACCA sees value in the IAASB's setting out more clearly the interactions between ISA 570, ISA 701 and ISA 706. The Australian Auditing and Assurance Standards Board (AUASB) has developed a flowchart that sets out some of the interactions (AUASB 2015: Appendix 1). Alternatively, the IAASB could decide to relax the detailed requirements on how the standards interrelate in favour of more general principles of useful disclosure.

3.3 GOOD PRACTICE IN DISCLOSURE

While ISA 701 defines what must be disclosed within KAMs, it does not prescribe how KAMs themselves are to be disclosed. There are some indicators in the application material to ISA 701 of ways to make the disclosures more useful, for example by cross-referencing the KAMs to management's disclosures in the notes to the accounts.

ACCA also observed some other examples of good practice:

- using two columns or a table to distinguish each KAM and its description from the procedures undertaken by the auditor in response
- disclosing the monetary amounts of the balances in the financial statements to which the KAM refers
- providing a list of KAMs at the beginning of the report, so that they can be appraised together and more easily compared between companies.

While these are simple examples, they can greatly increase the readability and accessibility of the Key Audit Matters section of the audit report. Given that some readers of the annual report are using the audit report as an index to the rest of the financial statements, such improvements to the structure of the Key Audit Matters section could have considerable impact on the overall usefulness of the financial statements. It is therefore an area that would benefit from further commitment to good practice from auditors.

3.4 CONSIDERING THE RISK OF FRAUD

Unless rebutted, there is a presumption in ISA 240 that there is a risk of material misstatement due to fraud in revenue recognition (ISA 240.26). Hence, it is very likely that the issue of fraud in revenue recognition and what the auditor has done to address it will form part of the discussion between the auditor and the audit committee. And therefore it will, in almost all cases, be a candidate for inclusion as a KAM. Whether it is selected as a KAM will depend on whether it is 'of most significance in the audit of the financial statements in the current period'.

'Not every business would have [fraud] as a significant risk'

Roundtable participant, UAE

In the first year of implementation in the UK, most audit reports did include the risk of misstatement due to fraud in revenue recognition as a KAM. The FRC's first year review was critical, noting that it was unhelpful for there to be KAMs that are generic rather than specific and that such disclosure did not comply with the requirement for KAMs to be 'of most significance... in the current period'. As a result, disclosure of fraud in revenue recognition as a KAM dropped significantly in the second year and subsequent years in the UK.

In the countries in the scope of ACCA’s research, there were a relatively small number of audit reports that referred to fraud in revenue recognition as a KAM.

In the countries in the scope of ACCA’s research, there were a relatively small number of audit reports that referred to fraud in revenue recognition as a KAM. A much greater number of audits identified revenue recognition as a KAM without referring to fraud (Figure 3.1). In many cases, this was because the KAM was based on the complexity of, or judgement involved in, revenue recognition, such as in long-term contract accounting.

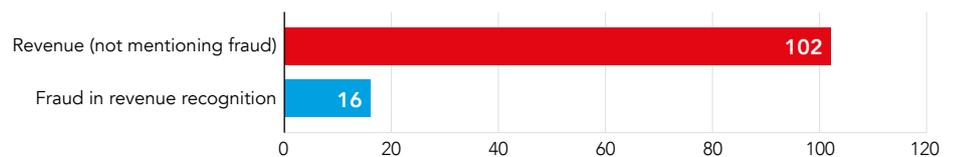
On the other hand, some KAMs did refer to concepts that are similar to fraud, while avoiding using the word itself. For example, one audit report refers to a risk that revenue is inappropriately reported to achieve desired financial results’, which could have been more directly described as ‘fraud’ but was not.

‘If you are saying there is a risk of fraud, you have to pinpoint where it is, for example by linking it to a significant account or assertion, before it can become a KAM.’
Auditor, Cyprus

The feedback from participants at roundtables supported the infrequent mention of fraud. It would be appropriate in those circumstances where it had been one of the most important areas of the audit in the period, but otherwise participants did not expect it to be included within the KAMs.

There could be value in further research to establish whether this disclosure meets public expectations on the auditor’s approach to fraud and the demonstration by the auditor of professional scepticism.

FIGURE 3.1: Comparison of KAMs mentioning fraud and those mentioning only revenue





4. Feedback from roundtable participants

In addition to its desktop research, ACCA held roundtables in Greece, Cyprus, Romania, Abu Dhabi and Oman to hear first-hand views of preparers, audit committee chairs, audit partners and regulators about the changes to audit reports. In the case of Greece, these discussions were prospective, as new audit reporting there had not been finalised; in other countries, the discussions were retrospective.

Some of the main insights are below.

4.1 AUDIT REPORTS NOW CONTAIN MUCH MORE USEFUL INFORMATION, BUT REPORTS ARE LONGER

Roundtable participants could see that audit reports now contained much more information that was useful to readers. Nonetheless, there was some scepticism as to whether this information was presented in a useful way. One audit committee member commented: 'in regards to transparency and openness, it definitely helps, however I am not sure that it fully addresses the issue. We perceive [the new audit report] as an additional long report included within other long reports and no one can read them all'. This point of view was echoed by an audit partner, who feared that 'we end up having a report of four to seven pages that is carefully drafted form a

legal point of view. With the opinion paragraph first, the rest will be ignored by many unless someone wants to understand what happened and reads each section'.

Participants were muted on the benefits for investors. As noted above, it was thought that the increased length of audit reports might be off-putting to many users. At the same time, participants thought that the more sophisticated users were unlikely to read the audit report.

On the other hand, other participants argued that the information in KAMs was being used. Whereas in the past, users might have referred to the audit report only to see whether it was unqualified, now there is feedback that users are using the audit report as an index to the most important areas of the annual report.

4.2 THERE ARE CONCERNS ABOUT THE COMPLEXITY OF LANGUAGE IN KAMs

As well as concerns about extent, some participants expressed misgivings about the complexity of language used in KAMs. Because financial reporting can be complex, and KAMs focus on the most complex judgements in the audit process, the language used to describe KAMs may be difficult to understand, particularly for less sophisticated investors.

'Whatever you do in the auditor's report, with how sophisticated accounting standards are at the moment, no-one can read them.'

Auditor, Cyprus

ACCA's reviews of audit reports did not identify this concern in practice. For most of the audit reports reviewed, the KAMs used plain language that was easy to understand. This suggests that the concern, while reasonable, can be overcome – at least to some degree – by auditors.

4.3 THE NUMBER OF KAMs – WHY DOES THE UK HAVE SO MANY?

One consistent finding was the high number of KAMs reported by auditors of listed companies in the UK compared with other countries. Within this report, UK companies were surveyed only to the extent that they had dual listings in other countries, such as South Africa. Even in this small sample, the average number of KAMs, at 4.1, was significantly greater than the next highest country, Zimbabwe. Overall, in most countries there were two to three KAMs per company.

Even though companies had made a promising start with reporting, the impact of KAMs may fall short of its full potential if users do not make use of the new reporting.

The UK was the first country to adopt KAMs, as the Financial Reporting Council (FRC) decided to adopt the standards early in 2013. As both the standard-setter and audit oversight body for listed company auditors in the UK, the FRC was able to provide the right balance of encouragement to, and regulation of, auditors. For example, in the first year, many auditors disclosed all their significant risks as KAMs, including the 'deemed' significant risks of fraud in revenue recognition and management override of controls. Following a review of implementation in the first year, the FRC was able to discourage auditors from repeating this approach in subsequent years.

'We believe there should be two to four KAMs, and the statement should be no more than two to three pages or it may lose impact.'

Roundtable participant, Oman

This would seem to underscore the importance of active, sensible regulation to ensure that good practice is encouraged and that auditors do not retreat into the perceived safety of formulaic or 'boilerplate' disclosures. In addition, auditors should be given a clear message by regulators that it is better to disclose more than to disclose less. This can be done in part by highlighting examples of good practice in audit reports.

4.4 SOME USERS MAY HAVE BEEN LEFT BEHIND

At the roundtables in the Middle East, participants commented that not all users of annual reports were aware of the new auditor reporting. Even though companies had made a promising start with reporting, the impact of KAMs may fall short of its full potential if users do not make use of the new reporting. There is scope for the IAASB to consider whether and how to communicate to users of annual reports the new style of auditor reporting.

4.5 THERE IS SOME INTEREST IN KAMs FROM LARGE UNLISTED COMPANIES

Some preparers commented that they might consider asking their auditors for a report prepared in accordance with ISA 701, even though the standard would not be mandatory for their audit. This was largely motivated by a desire to increase the credibility of their financial reporting with providers of capital. So it is clear that some preparers perceive there to be value in the greater transparency over the audit process that KAMs provide.



5. Examples of good practice

A number of KAMs were identified that provided real insights into specific issues that were identified during the audit. Some of these are highlighted below.

5.1 ISA HOLDINGS LIMITED (SOUTH AFRICA)

MATTER	AUDIT RESPONSE
Change in Financial Directors and Financial Managers	
<p>During the 2017 financial year, the financial director of ISA Holdings Limited resigned as at 31 May 2016. The financial manager of ISA Holdings Limited had also resigned during the period. A new financial manager has been appointed.</p> <p>Based on the fact that key financial staff members had left the company there is an increased risk of misstatement due to the potential impact of this on the functioning of the controls and record keeping of the company.</p> <p>During the current financial year, the entity did not have a full time appointed executive financial director. The entity however, engaged in consultation with the JSE regarding the employment of a part time executive financial director and his was permitted in terms of Section 3.84 (g) of the JSE Listing Requirements which does allow the financial director to be employed on a part time basis in special circumstances.</p> <p>The entity had also employed a suitably qualified financial manager within a reasonable time frame.</p>	<p>Our procedures in relation to the changes of staff in the financial department included:</p> <ul style="list-style-type: none"> – The testing of controls around the Revenue, Purchases and Payroll cycles. Based on the testing we had performed there were no exceptions or changes identified within the control functions other than a change in personnel performing such controls. We focused our testing on ensuring that there were mitigating controls in place to accommodate the change in personnel. – We specifically instructed staff to apply a higher level of professional scepticism and placed more reliance on substantive work. <p>We confirmed substantively that the company had complied with the JSE Listing Requirements through the appointment of a part time financial director within a reasonable time frame following approval by the JSE.</p>

Excerpt from the ISA Holdings Limited 2017 annual report

The company had experienced turnover of its senior finance team during the year, which affected its ability to prepare the financial statements. The auditor referred to this issue in its Key Audit Matters section (Figure 5.1). In addition, although not required by ISA 701, the auditor disclosed the findings arising from its audit procedures.

5.2 COURTEVILLE BUSINESS SOLUTIONS PLC (NIGERIA)

<p>Labour Turnover</p> <p>Included in the payables disclosed in Note 15 to the financial statements is the benefits due to the Management Staff that left the company during the period.</p> <p>In evaluating the value of the outstanding liability our procedures incorporated a combination of test of the company Internal Controls and engagement policies of the company.</p> <p>The exit of the management staff did not have a serious impact on the going concern of the company.</p> <p>In similar vein, the company has not contravened any sections in the Nigerian Labour Law.</p>
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Excerpt from the Courteville Business Solutions Plc 2016 annual report

As with ISA Holdings Limited, the company had experienced turnover of key staff during the year. As a result, the issue of labour turnover was considered to be a KAM. While the description of the audit response could be more detailed, there is a clear statement of the findings, a disclosure that is not required by ISA 701.

Auditors can perform audit procedures over non-GAAP measures in the financial statements.

5.3 OLYMPIA CAPITAL HOLDINGS LIMITED (SOUTH AFRICA)

Significant Component – Kalahari Floor Tiles (KFT) (Continued)

A concentration risk exists as 62% of Group profit is from KFT and 77% of the consolidated profits are from 2 component audited subsidiaries. There is a risk that the component auditor may not detect misstatements in the financial information.

How our audit addressed the key audit matter: We reviewed the account balances, classes of transactions and disclosures affected by the likely significant risks and requested the subsidiary's component auditor to perform an audit of only those account balances, classes of transactions and disclosures that are likely to have a significant risk of material misstatement of the group financial statements.

Among other balances we identified inventory as a balance (Kshs. 182 million) that can have a significant risk of inventory obsolescence. To check on potentially obsolete inventory, we requested the component auditor to perform specified audit procedures on the valuation of inventory at KFT that holds a large volume.

Excerpt from the Olympia Capital Holdings Limited 2017 annual report

The group auditor identified as a KAM the existence of a high concentration of group profit in one component. As a result, there was a heightened risk that the component auditor may have failed to detect misstatements. In response, the group auditor issued specific instructions to the component auditor and performed additional procedures centrally.

5.4 ANGLO AMERICAN PLC (SOUTH AFRICA LISTING, UK AUDITOR)

Special items and remeasurements (note 6)

The assessment of the appropriateness of items disclosed within 'special items and remeasurements' is a key judgement because of their impact upon the reporting of the underlying financial performance achieved by the Group.

In the context of our review of the overall income statement and with reference to the recently published guidance from the European Securities and Market Authority (ESMA) we considered and challenged each item disclosed within 'special items and remeasurements' as defined in note 6 to the financial statements.

We determined whether such categorisation is appropriate and consistent with the Group's stated policy and past practice for recognition of such items, and whether, taken as a whole, the income statement is fair and balanced in its presentation.

We are satisfied that all items included within 'special items and remeasurements' display no indication of management bias in the categorisation and that where relevant the categorisation was consistent with prior practice.

We consider that the related disclosures are also appropriate.

Excerpt from the Anglo American plc 2016 annual report

The auditor included 'special items and remeasurements' as a KAM, on the grounds that management considers these items important for understanding the group's underlying financial performance. This KAM is interesting, as it shows that auditors can perform audit procedures over non-GAAP measures in the financial statements.



6. Statistics and detailed findings

The findings in this report are drawn from an analysis of approximately 560 audit reports from Brazil, Cyprus, Kenya, Nigeria, Oman, Romania, South Africa, the UAE and Zimbabwe.

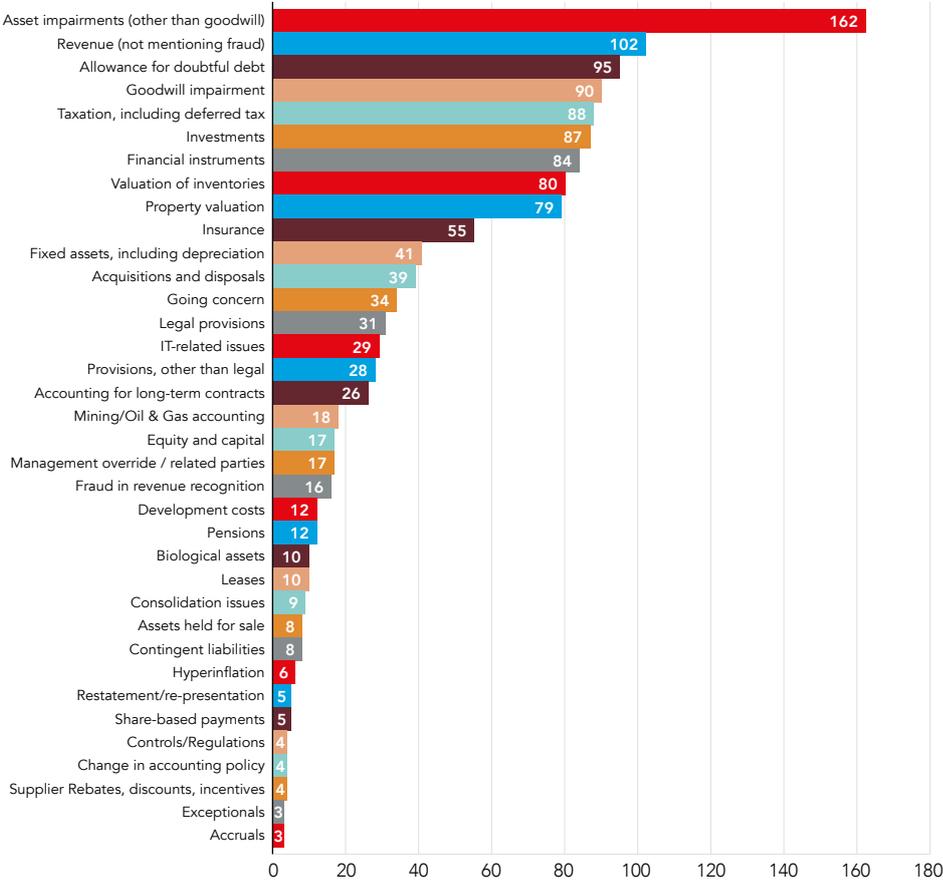
In addition, owing to dual listings in South Africa, a small number of reports issued by firms from other countries are included, the largest of which is the UK. Some further analysis of the data is presented below.

6.1 TYPES OF KAM REPORTED

In total, there were 1,321 KAMs reported across 560 audit reports. By some margin, the most common KAM relates to asset impairment, mentioned in over a quarter of all reports (Figure 6.1). Revenue recognition, excluding any reference to fraud, is the second most common KAM, followed by doubtful debt, goodwill impairment and considerations relating to tax, including the valuation of deferred tax assets. The high ranking of goodwill impairment and tax is in line with expectations and indicates that auditors challenge the valuation of key assets to ensure that they are not overvalued.

In collecting the data for revenue recognition, as noted above in section 3.4 and Figure 3.1, a distinction was made between KAMs that referred to fraud in revenue recognition and those that referred to revenue recognition but did not mention fraud in that context.

FIGURE 6.1: Subject matter covered by KAMs



It suggests there is scope for auditors to say even more about the matters that are of most importance to the audit, and that regulators should encourage auditors to do so.

The relatively high ranking of doubtful debt was surprising. Traditionally, this has not been seen as a high risk of material misstatement, given the persuasiveness of post balance sheet cash. Feedback from the Cyprus roundtable was that the drive for faster reporting timetables may mean that this evidence is not available when the audit is finalised and that local economic conditions may lead to doubtful debt being a higher risk in some countries.

2013. In the first year that KAMs were introduced, many audit firms included 'fraud in revenue recognition' and 'management override of controls' as KAMs in all audit reports. Even though this practice reduced in subsequent years, owing to feedback from the FRC, firms have continued to report a higher number of KAMs than firms from other countries.

By contrast, our data indicated that the rest of the world has tended to report a smaller number of KAMs than the UK did. This finding was replicated in Singapore and Malaysia. It suggests there is scope for auditors to say even more about the matters that are of most importance to the audit, and that regulators should encourage auditors to do so.

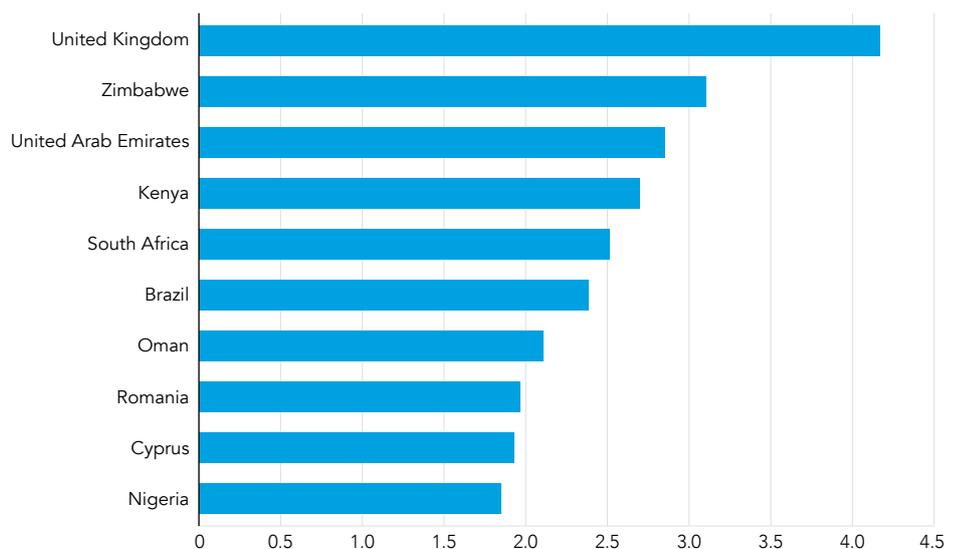
6.2 NUMBER OF KAMs BY COUNTRY

This data is derived from each company's country of domicile, which can be different from its country of listing. Therefore, Figure 6.2 includes companies registered in the UK, because they are listed on the Johannesburg stock exchange. Countries with fewer than five KAM audit reports have been excluded for the purposes of this graph.

Overall, the number of KAMs per audit ranges from 1.9 in Nigeria to 4.1 in the UK, with most within a range of two to three KAMs per audit.

The outlier position of the UK is interesting. The number of KAMs in the UK has been high since their introduction by the Financial Reporting Council in

FIGURE 6.2: Average number of KAMs per company, in the sample countries



It appears that KAMs in some countries would benefit from further focusing and development to ensure that they relate to the areas of the audit requiring the most careful judgement and are described in sufficient detail that the reader can understand them.

6.3 TYPES OF KAM BY COUNTRY

This data is prepared on the same basis as that in the previous section. The KAMs have been categorised by type, ie relating to controls, assets, liabilities, asset impairments and industry-specific issues. The proportion of KAMs of each type is shown in Figure 6.3.

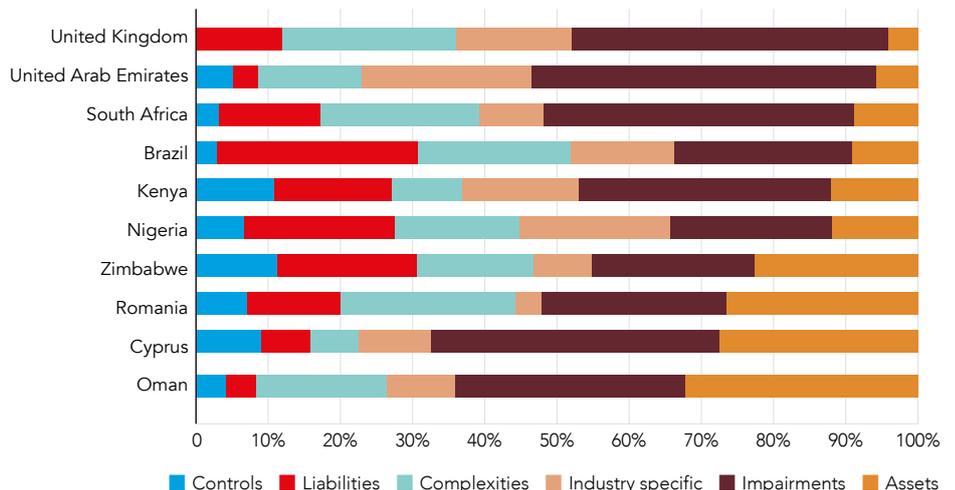
Given that KAMs are the matters that were of most significance in the audit of the financial statements, it would be expected that most would relate to the riskiest aspects of the audit, such as asset impairments, complex matters, completeness of liabilities, internal controls or specific industry or regulatory matters. In light of this, the proportion of KAMs that related to assets, as opposed to asset impairment, was surprising.

To some extent, this may relate to specific market conditions: for example, in Cyprus, concerns over counterparty risk made debtor recovery a particularly sensitive audit issue. In addition, items discussed in some KAMs may have been described as 'assets' where the underlying issue related to a more complex issue, such as impairment. While ACCA's methodology attempted to address such misclassification, it may not have been entirely eliminated.

Even so, it appears that KAMs in some countries would benefit from further focusing and development to ensure that they relate to the areas of the audit requiring the most careful judgement

and are described in sufficient detail that the reader can understand them. Regulatory encouragement in this area would be helpful in assisting firms to improve the usefulness of disclosures.

FIGURE 6.3: Types of KAM reported, by country



The relatively small number of KAMs within banks and financial services was a surprise, given the risky nature of this sector.

6.4 NUMBER OF KAMs BY INDUSTRY

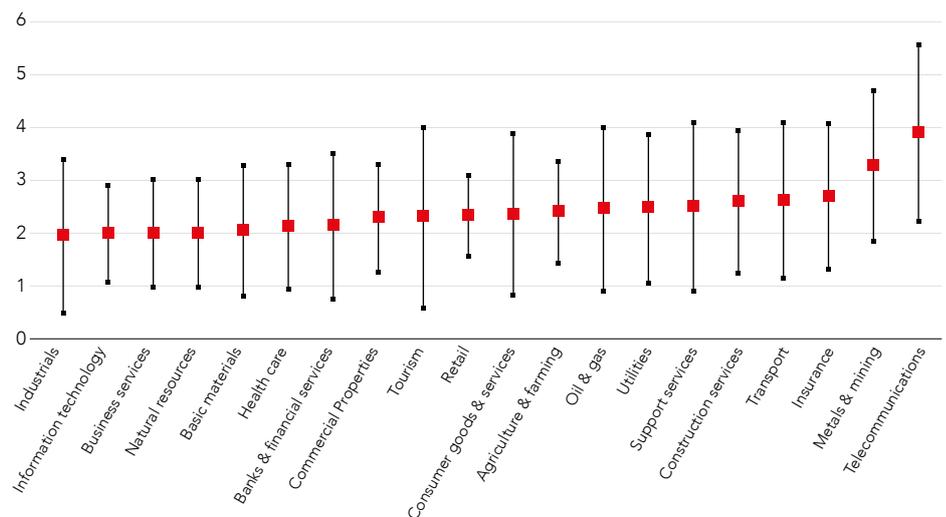
Figure 6.4 shows the average number of KAMs in each industry, together with error bars showing one standard deviation from the mean number of KAMs in that industry. Analysis of the number of KAMs by industry showed considerable variation, with some audit reports for a particular industry reporting one KAM, or in some cases no KAMs at all, while others had as many as eight KAMs. Very high numbers of KAMs tended to be the exception, however, with some audit reports aggregating similar KAMs together, for example long-term and short-term insurance liabilities, to simplify the reporting. As a result, it was difficult to assess the number of KAMs objectively, and these figures should be considered indicative rather than absolute.

The average number of KAMs ranged from 1.9 in the industrials sector up to 3.9 in telecommunications. Within telecommunications, the most common KAMs included revenue recognition, tax and goodwill impairment.

The relatively small number of KAMs within banks and financial services was a surprise, given the risky nature of this sector. The most commonly mentioned KAMs within this sector were asset impairments (excluding goodwill), financial instruments and, to a lesser extent, valuation of investments.

ACCA would have welcomed greater transparency of the risks of material misstatement that were of most significance during the audit. As with the comment in section 6.2 above, regulators’ encouragement for auditors to expand upon the range of KAMs disclosed would be helpful.

FIGURE 6.4: Numbers of KAMs on an industry-by-industry basis





7. Conclusion

The research underlying this report aimed to understand the extent to which KAMs had achieved the IAASB’s objective of providing more useful information for investors. It found high-quality reporting in audit reports, which suggests that auditors have successfully risen to the challenge.

But the impact of KAMs was not limited to improving the quality of information for investors. The research revealed three additional benefits of KAMs to the financial reporting process:

- KAMs encourage better conversations between the auditor and those charged with governance; this in turn contributes to better governance
- KAMs help the auditor to focus on the areas of the audit requiring the most careful judgement; this in turn contributes to higher audit quality
- KAMs give preparers incentives for revisiting financial reporting and disclosures in areas related to those KAMs. This in turn leads to better financial reporting.

Together, these contribute to a much broader impact of KAMs on the financial reporting process beyond merely providing better information for investors.

Because of these wider benefits, ACCA calls upon regulators to take a balanced approach to enforcement to ensure that ultimately the full benefits of KAMs can be realised. While there is room for improvement in some of the reports within the scope of this review, an approach to enforcement that is too heavy-handed may fail to encourage better KAM reporting, but instead motivate a more defensive and ‘boilerplate’ approach to KAMs. In ACCA’s view, the way that the UK FRC encouraged firms while identifying areas for improvement is a case study in good regulation.

Firms may wish to challenge themselves to see whether the number of KAMs can be increased without compromising quality.

Appendix

METHODOLOGY

The findings in this report are based on an original analysis of approximately 560 audit reports from stock exchanges in Brazil, Cyprus, Kenya, Nigeria, Oman, Romania, South Africa, the UAE, and Zimbabwe. With the exception of those from Brazil and Cyprus, all audit reports were obtained in the English language. The audit reports from Brazil were obtained in Portuguese and were translated using Google Translate. These translations were reviewed for any translation artefacts with a bilingual English/Portuguese speaker and then processed. The audit reports from Cyprus were obtained in Greek and were processed by a bilingual English/Greek-speaking ACCA member with expertise in auditing.

Each report was then processed against a questionnaire, which identified the following aspects.

- Company name
- Business sector
- Financial year-end
- Audit firm name
- Audit firm network
- Audit firm engagement partner (where named)
- Audit report date
- Whether the report was modified
- The number of KAMs
- The types of KAM.

The KAMs in each report were coded against the following types, which are loosely based upon the methodology used by the UK Financial Reporting Council in its reporting on the implementation of KAMs in the UK. Where there was ambiguity as to how to classify an item, these were reconciled with the assistance of another professional accountant.

- Management override/related parties
- Fraud in revenue recognition
- Goodwill impairment
- Asset impairments (not goodwill)
- Assets held for sale
- Taxation
- Revenue excluding reference to fraud
- Provisions
- Legal provisions
- Acquisitions/disposals
- Investments

- Pensions
- Financial instruments
- Insurance
- Property valuation
- Controls/regulations
- Exceptionals
- Development costs
- Mining/oil/gas accounting/concessions
- Going concern
- Share-based payments
- Accruals
- Capitalisation/equity
- Valuation of inventories
- Allowance for doubtful debt
- Accounting for long-term/complex contracts
- Supplier rebates, discounts, incentives
- Contingent liabilities
- IT related
- Biological assets
- Leases
- Hyperinflation
- Restatement/re-presentation
- Fixed assets
- Consolidation and component auditor issues
- Change in accounting policy

The countries selected for review were chosen from those that have audit reports that are publicly available from the national stock exchange and that have adopted ISA 701 and that overall provide an appropriate level of global representation.

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PI-KEY-AUDIT-MATTERS