KPMG

Key Audit Matters

KPMG Indonesia
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New auditor's report requirement - Communication of key audit matters

This article aims to explain the concept of key audit matters that are part of new auditor's report.

Summary

Enhanced Auditor's Report:

Without changing the scope of an independent audit, enhancement made to the auditor's report opens the door for the auditor to give users more insight into the audit and improve transparency.

Key Audit Matters:

This is the most significant change introduced by the new auditor reporting standard, i.e. the auditor to include descriptions of key audit matters in the auditor's report.

Effective date:

The new and revised Auditor Reporting Standards are planned to be effective for the audit of financial statements for periods beginning on or after 1 January 2022.

In July 2021, the Indonesian Institute of Certified Public Accountants (IAPI) finalized the new and revised auditor reporting standards which include a new Standard on Auditing (SA) 701, Communicating Key Audit Matters (KAMs) in the Independent Auditor's Report. This standard on auditing is expected to provide greater transparency about the audit that would be performed and increase in the communicative value of an auditor's report.

SA 701 requires an auditor to describe in the auditor's report of listed entities about the matters that, in the auditor's professional judgement, were most significant in the audit of financial statements in the current period. SA 701 applies to audits of complete sets of general-purpose financial statements of listed entities *(emiten)*[1] and in circumstances when the auditor otherwise decides to communicate KAMs in the auditor's report. It is also applicable in case the law or regulation requires an auditor to communicate KAMs in the auditor's report.

[1] Emiten: An entity whose shares or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

You may have previously taken only a few minutes to read through the auditor's report...

In the near future, you may have to spend as much as an hour to read the report in full detail.

What can financial statements' users expect from the changing landscape of the report?

For many years, we may not pay full attention to the entire content of the auditor's report. Some readers are just interested in a "pass/fail opinion", and not how the audit is conducted or the areas that are particularly focused on in the audit. This may be because the auditor's report for each entity is written in standardized descriptions. From now on, we may have to take a more careful look at the report, especially those for listed entities. According to the new Standard, auditors will be required to communicate key audit matters and how the audit is performed in the auditor's reports for listed entities. Such details have to be tailored for each entity, which will provide more insights into the audit. The changes will also inspire greater transparency financial reporting, which will be beneficial for the users.

What are the Key Audit Matters (KAMs)?

- Those matters that, in the auditor's professional judgement, were most of significance in the audit of financial statements of the current period.
- KAMs are selected from matters communicated with TCWG[2].
- 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 risk identified.
  b) Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
  c) The effect on the audit significant events or transactions that occurred during the period.

Inclusion of KAMs – Significant change in the auditor's report

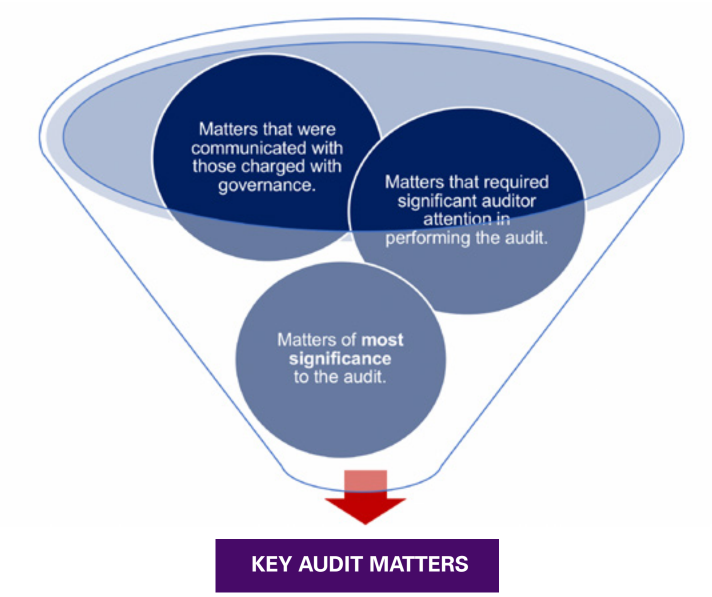
- The most significant change introduced by SA 701 in the auditor's report of listed entities is the communication of KAMs.
- KAMs have been defined to mean those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with TCWG.
- KAMs, in most of the cases, would relate to significant or complex matters disclosed in the financial statements. For instance, valuation of goodwill and other long-term assets, valuation of financial instruments, difficult or unique aspects of revenue recognition, assessment of impairment, taxation matters, accounting for significant acquisitions, etc.

Benefits of KAMs

- **Management and TCWG:** timely communication of KAM is likely to encourage management and TCWG to enhance or make new disclosures in the financial statements or other reports in light of the fact that the matter will be communicated in the auditor's report. For instance, providing robust information about the sensitivity of key assumptions used in accounting estimates or an entity's rationale for a particular accounting practice.
- **Users of financial statements:** KAM is expected to provide additional information that may assist users in understanding the entity and areas of significant management judgement in the audited financial statements.

Determination of KAMs – a funnel approach

SA 701 provided a funnel approach to determine which matters are required to be reported as KAMs in the auditor's report. According to the approach, following steps should be followed while determining a KAM:



Step 1: KAMs should be identified from the matters communicated with TCWG. These matters could, inter alia, include the auditor's responsibilities in relation to the financial statements audit and significant findings from the audit.

Step 2: From the matters communicated to TCWG, identify the matters that require significant auditor's attention. These primarily relate to matters that pose challenges to the auditor in forming an opinion or obtaining evidence that in his/her judgement was sufficient and appropriate under the circumstances.

While determining such matters, an auditor is required to consider the following:

- Areas of higher assessed risk of material misstatement or significant risks identified
- Significant auditor's judgements relating to areas in the financial statements that involve significant management judgement, including accounting estimates that have been identified as areas of high estimation uncertainty
- Effect on the audit of significant events or transactions that occurred during the period. For instance, matters which have significant effect on financial statements or the audit and significant economic, accounting, regulatory, industry or other developments that impact the management's assumptions and judgements.

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[2] Those Charged with Governance (TCWG): The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, TCWG may include management personnel, for example, executive members of a governance board of a private or public sector entity or an owner-manager.

Step 3: An auditor needs to determine which of the matters identified in Step 2 are of most significance in the audit of the financial statements of the current period.

Determining which, and how many, of those matters that require significant auditor's attention are of most significance in the audit is a matter of professional judgement. Further, the number of KAMs to be included in an auditor's report may be affected by the following:

- Size and complexity of the entity
- Nature of its business and environment, and
- Facts and circumstances of the audit.

There is no threshold for the number of KAMs that need to be communicated by an auditor. Different entities in the same industry can have different KAMs as the identification of KAM depends on the risk assessment process of the auditor and entity-specific conditions and circumstances. Similarly, it is possible for KAMs to be different in different years but cannot be entirely different.

SA 701 provides certain factors that could be considered while identifying matters of most significance. These, *inter alia*, include:

- Areas where an auditor had more in-depth, frequent or robust interactions with TCWG on more difficult or complex matters
- Significant delays in management providing required information
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested
- Severity of control deficiencies.

Manner of communicating KAM

- The description of each KAM in the KAM section of the auditor's report should include a reference to the related disclosure(s), if any, in the financial statements, as to:
  a. Why a matter is considered as one of the most significance in the audit and therefore, determined to be a KAM, and
  b. How the matter is addressed in the audit.
- It is important to note that communicating KAMs in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole and not a separate opinion on individual matters reported as KAM.

Going concern as a KAM

- SA 701 highlights that a material uncertainty related to going concern is, by its nature, a KAM. These matters are to be reported in accordance with SA 570, Going Concern.
- In the KAMs section, reference to the basis of qualified/adverse opinion or the material uncertainty related to going concern section should be given.

Close call situations

- There could be events or conditions which may cast significant doubt on an entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists. These are generally referred to as 'close call situations'.
- In such a case, an auditor should evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions. These may be fundamental to the understanding of the entity and can be considered and reported as KAMs.

Interplay between Emphasis of Matter (EOM), Other Matter (OM) and KAM section

- SA 706 (Revised), Emphasis of Matter Paragraphs and Other Matter paragraphs in the Independent Auditor's Report establishes mechanisms for auditors of financial statements of all entities to include additional communication in the auditor's report through the use of EOM and OM paragraphs when the auditor considers it necessary to do so.
- These paragraphs are presented separately from the KAM section in the auditor's report.
- SA 701 provided following guidance with respect to EOM, other matter and KAM section:
  - o **In case a matter has been determined to be a KAM:** The auditor is required to include the matter in the auditor's report in accordance with SA 701. The auditor should not use an EOM paragraph or other matter paragraph to highlight the matter instead of the requirements of SA 701.
  - o **In case a matter is not determined to be a KAM as per SA 701 (i.e. it did not require significant auditor's attention):** If the matter is fundamental to the users' understanding of the financial statements, then the matter should be reported in an EOM paragraph in the auditor's report in accordance with SA 706. For instance, in the following circumstances, an auditor would consider it necessary to include an EOM section:
    - An uncertainty relating to the future outcome of exceptional litigation or regulatory action
    - A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report
    - A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Presentation of KAM

- KAMs should be presented as a separate section after the basis for opinion section of an auditor's report.
- In case KAMs identified relate to a modification, a statement to this effect is to be included under the KAMs heading.
- In case, 'material uncertainty relating to going concern' section is required as per revised SA 570, then KAMs section is placed after that section.
- Based on the auditor's judgement as to the relative significance of the information included in the EOM paragraph, an EOM paragraph may be presented either directly before or after the KAMs section.

Types of KAMs not to be reported

- Under the following circumstances, a matter determined to be a KAM is not required to be communicated in the auditor's report:
  a. Law or regulation precludes public disclosure about the matter.
  b. The auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This will not be applicable if the entity has publicly disclosed information about the matter.
- In such a case, a written representation from management, and, when appropriate, TCWG could be obtained as to why public disclosure about the matter is not appropriate, including management's view about the significance of the adverse consequences that may arise as a result of such communication.
- Apart from the above, there could be very limited situations (such as listed entity with very limited operations) where there are no KAMs to be communicated. However, in such a case also, KAMs section will be given in the auditor's report.

Changes for ALL entities

However, there are other changes in the auditor's report that are applied for ALL entities, such as:

- Report reordered – opinion required to go first
- Revised description of management's (and TCWG) responsibilities, including an assessment of the entity's ability to continue as a going concern and if the going concern basis of accounting is still appropriate
- Revised description of the auditor's responsibilities, including a conclusion on the appropriateness of management's use of the going concern basis of accounting.

What are the changes in the audit report?

Current Audit Report

1. Title and addressee
2. Management's responsibility
3. Auditor's responsibility
4. Basis for opinion (for modification)
5. Auditor's opinion
6. EOM (if any)
7. Other matters (if any)
8. Report on Other Legal and Regulatory Requirements (if any)
9. Signature
10. Date of auditor's report
11. Address

Enhanced Audit Report

1. Title and addressee
2. Auditor's opinion
3. Basis for opinion
4. Material uncertainty related to going concern (if any)
5. EOM (if any)
6. KAMs

Starting with listed entities

7. Other matters (if any)
8. Other information (if any)
9. Management and TCWG' responsibilities
10. Auditor's responsibility
11. Responsibility on other reporting
12. Name of the engagement partner
13. Signature
14. Address/date of auditor's report

Timeline

Now
How much do you know about KAMs?

Exposure Draft SA 701 issued on 27 January 2021

IAPI finalized SA 701 in July 2021

The new requirements are effective for the audit of financial statements for the periods beginning on or after 1 January 2022.

Example of KAMs

Revenue Recognition	
Risk Description	**Our response**
Refer to note 2(t) "Revenue" and note 3(c) "Passenger revenue recognition" for the relevant accounting policy and a discussion of significant accounting estimates. Passenger revenue is not recorded immediately on sale of flight tickets but is deferred to be recorded at a later time as revenue in the profit and loss account when a passenger is flown. Such deferred revenue is presented on the statement of financial position as sales in advance of carriage and is measured based on the sales price to the customer, net of ticket breakage (tickets sold but not utilized at flight date), discounts and rebates. The global Covid-19 outbreak was declared by the World Health Organization on 11 March 2020 to be a pandemic and many countries have put in place travel restrictions and passenger requirements in response. These travel restrictions have resulted in a significant decline in global travel demand, and consequently, the Group has cancelled a significant number of its passenger flights in the near-term. These flight cancellations have caused a significant reduction in passenger revenue and forward bookings and also necessitated the payment of certain customer refunds. In addition, the Group has initiated changes in ticketing terms and conditions for certain affected ticket holders which include the extension of the ticket validities, amongst other measures. With these measures, historical trend information which has been used in the past, including to assist in our analysis of the reasonableness of passenger revenue and sales in advance of carriage and estimated ticket breakage rates requires reexamination. In addition, flight tickets sold often involve multiple flight sectors and partner airlines. The amount of revenue to be recognized for each flight as it is flown relies on complex internal IT systems that handle large volumes of transaction data and includes the exchange of information with industry systems and partner airlines. As a result of these complexities, this is a key focus area in our audit.	We held discussions with senior management to understand the Group's plans regarding ticket holders impacted by cancelled flights arising from the Covid-19 pandemic. Through these discussions, and reviews of the Group's announcements and documented internal policies and approvals, we understood the Group's changes to the ticketing terms for these affected ticket holders. To analyze the financial impact of cancelled and disrupted flights arising as a result of the Covid-19 pandemic, we performed data and analytical routines over passenger revenue recognized during the flight cancellation period as well as an analysis of the impact of flight cancellations on forward bookings that are recorded as sales in advance of carriage. We also performed test of details over a sample of passenger revenue to ascertain its appropriate recognition on flight date. In addition, we recomputed the underlying operating statistics of the Group to enable us to perform an analytical review of passenger revenue balances given the significant changes witnessed as compared to historical periods arising from the impact of Covid-19. We assessed the revised ticket breakage estimates taking into account revisions to ticket terms. To check the accuracy of the revenue recorded by the passenger revenue systems, we tested the relevant computer system controls, including the user access, program change controls and application controls over internal passenger revenue systems. Our tests of these controls were designed to determine whether these key computer systems controls operated as they were designed, and whether they were protected from tampering of data or software logic that would result in inaccurate accounting information relating to passenger revenue. Computer system controls were tested selectively; these included those relating to the completeness of transfers of data between systems, ticket validation to identify data errors and the assignment of ticket prices to each flight. Key manual controls were also tested to assess the appropriateness of the treatment applied to exceptions, and reconciliations of the Group's records with the outputs from shared industry systems and partner airlines. We obtained direct assistance from the Group's internal auditors to test the effectiveness of key controls in the passenger revenue accounting process at various overseas stations. Procedures we performed included planning the work to be performed by the Group's internal auditors, identifying the controls to be tested, and reviewing the work of the Group's internal auditors.

This example KAM was extracted from the Report to the members of United Singapore Airlines Limited as at 31 March 2020 (source: 2019/2020 Annual Report)

Acquisition	
Risk Description	**Our response**
Refer to Note 2 (significant accounting policies), Note 3 (key judgements involved are set out in the critical accounting judgements and key sources of estimation uncertainty) and Note 16 (transaction overview) to the financial statements. On 26 November 2019, the Group acquired a 79% shareholding in eLocal Holdings LLC for £98.8m. In addition, the Group entered into a put and call option agreement which means they will be required to purchase the remaining 21% equity interest over the next five years. As part of the transaction, a number of acquisition intangibles have been identified in relation to customer relationships, technology and domains. A high level of judgement is required in order to determine the fair value of these assets at the point of acquisition, as well as the fair value of the put option for the remaining 21% equity interest. Given this is a technically complex area with high levels of judgement, we identified a new key audit matter in relation to: • the valuation of acquisition intangibles; and • the valuation of the put and call options over the remaining 21% equity interest.	We understood the key controls the Group has in place to manage the risk of inappropriate conclusions being reached within the acquisition accounting assessment. We challenged the key accounting assumptions, most notably whether the presence of the put and call option over the remaining 21% equity interest constitutes a present ownership interest, as well as the judgement required to identify the split of potential cash payments under the put option between those which should be recognized at the transaction date and those which relate to post combination employee benefit expenses. We worked with our valuation specialists in order to: • challenge the methodology used by management in order to identify and fair value the intangibles, including the appropriateness of the discount rate used; and • independently recalculate the fair value of the put and call options. We also assessed the key assumptions within management's forecasts for reasonableness, including assessing whether the forecasts did not include post-acquisition events, such as the COVID-19 pandemic.

This example KAM was extracted from the Report to the Shareholders of HomeServe plc as at 31 March 2020 (source: 2019/2020 Annual Report)

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