



# Key Audit Matters

Auditor's report snapshot

August 2019  
KPMG in Sri Lanka



# Contents

<b>About this Publication</b>	<b>01</b>
<b>What is KAM</b>	<b>02</b>
Understanding Key Audit Matters	<b>03</b>
Consideration in KAMs	<b>04</b>
Determination of KAM	<b>04</b>
Value of Communicating KAMs	<b>05</b>
<b>Summary of modifications in the Auditor's Report</b>	<b>06</b>
<b>Analysis by Audit Firm</b>	<b>07</b>
<b>Reporting Of KAMs</b>	<b>07</b>
<b>KAMs by sector</b>	<b>08</b>
<b>KAMs by Subcategories</b>	<b>11</b>
<b>Illustration of KAMs</b>	<b>13</b>
<b>KPMG Clara: The future at your fingertips</b>	<b>14</b>
<b>Acknowledgement</b>	<b>16</b>
<b>About KPMG</b>	<b>17</b>

# About this Publication

In order to address global concerns about the effectiveness of company stewardship and the effectiveness of the financial statement audit a new auditing standard for reporting was issued globally and adopted in Sri Lanka.

Consequently auditors in Sri Lanka were required to amend their auditor's report effective for audits of financial statements for periods ending on or after 31st March 2018. As the principal communication between the auditor and users of audited financial statements, the new auditor's report is intended to be more informative and more transparent. The purpose of this publication is to provide an understanding of the Sri Lankan experience in the first year of reporting of key audit matters (KAMs). To prepare this publication we analyzed the new extended auditor's reports issued in Sri Lanka.

We also conducted online reviews of annual reports and analyzed the key audit matter, qualification, emphasis of matter, other matters and material uncertainty relating to going concern included in 280 annual reports of listed entities. We hope this publication provides further insight and learnings to help improve auditor reporting in Sri Lanka. Auditors decision making process in determining key audit matters is designed to select a number of matters which are more significant to the users of the financial statements, to improve their overall understanding on an entity's financial statements, including the auditor's report. Further KAMs also enhance the communicative value of the auditor's report by providing transparency about the audit that was performed.

The Standard promotes auditors to be entity specific in reporting their outcome rather than using standardized language.

One significant change in auditor's reporting standard is the implementation of SLAuS 701 (communicating key audit matters in the auditors report) where auditors are required to report key audit matters in their auditors report which require significant auditor attention.

The implementation of the above change to audit reports can be called the biggest change made to auditing standards in a long time. In order to provide better insight on the conduct of the audit, the audit reports may have to be more granular and KAMs should show a linkage of the impact on the entity arising from wider macro economic factors.

We at KPMG are committed to transparency about our audit and endeavor to provide shareholders a view behind the boardroom discussions about important audit issues that were discussed between the audit partner and those charged with governance.



“ KAMs also enhance the communicative value of the auditor's report by providing transparency about the audit ”

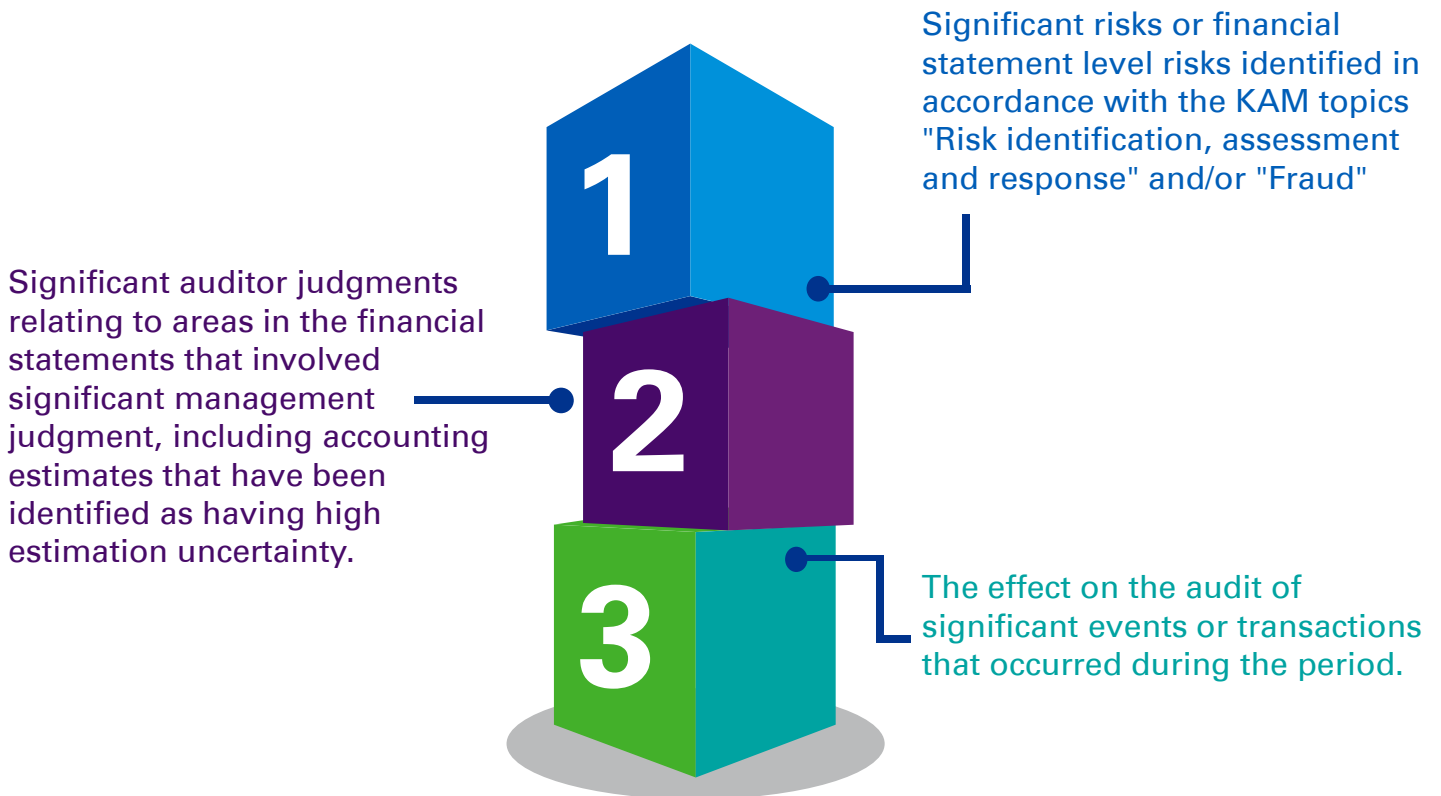
**Suren Rajakarier**

Partner,  
Head of Audit  
KPMG in Sri Lanka

# What is KAM?

Key audit matters are those matters that, in our 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.

We 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, we shall take into account the following



We shall determine which of the matters determined were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

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.

## Why are the auditors of listed companies required to report on KAMs?

Including KAMs in the auditor's report is a major breakthrough for both auditors and users. Similar reporting requirements were already in place for auditors in various jurisdictions. However, the widespread requirement to report KAMs for listed entities and other PIEs came about after the financial crisis, as stakeholders wanted to know more about the key areas that the audit covered.

In particular, investors questioned the relevance and transparency of the pass/fail auditors report and the 'boilerplate' language auditors used in their reports. As end users of the auditor's report, they urged auditors to provide more informative and transparent audit reporting, while providing deeper insight into the company.

## Understanding Key Audit Matters

### What KAMs do:



- Enhancing the communicative value of the audit report by offering better transparency about the audit.
- It provides additional information to users to understand the professional judgment of the auditors.
- It helps in understanding the areas of crucial management judgment in audited financial statements.
- May encourage users to further engage with the audit committee and management by using the information in KAMs.

### KAMs are not:

- A substitute of the preparer's view reported in the financial statements.
- Key audit matters are not a substitute for expressing a modified opinion.





## Consideration in KAMs

KAM includes specific required considerations in our determination of those matters that required significant auditor attention. These considerations focus on the nature of matters communicated with those charged with governance that are often linked to matters disclosed in the financial statements, and are intended to reflect areas of the audit of the financial statements that may be of particular interest to intended users. The fact that these considerations are required is not intended to imply that matters related to them are always key audit matters; rather, matters related to such specific considerations are key audit matters only if they are determined to be of most significance in the audit in accordance with auditing standard.

The auditors should consider:

1

Significant risks or financial statement level risks.

2

Significant auditor judgments relating to areas in the financial statements that involved significant events or transactions that occurred during the period.

3

The effect on the audit of significant events or transactions that occurred during the period.

## Determination of KAM – a funnel approach

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

Matters that were communicated with those charged with governance

Matters that require significant due attention

Matters of most significance to the audit

## Value of communicating KAMs



Communicating key audit matters helps better communication between the auditors and those charged with governance, this in turn contributes to better governance.



Reporting KAMs in the auditors report opens up transparency on the audit process relating to the auditors professional judgment. As there is a growing demand on transparency by the investors in the audit process.



KAMs help the auditor to focus on the areas of the audit requiring the most careful judgment; this in turn contributes to higher audit quality.



KAMs give preparers incentives to revisit financial reporting and disclosures in areas related to those KAMs; this in turn contributes to higher quality financial reporting.



KAM is expected to provide additional information that may assist users in understanding the entity and areas of significant management judgment in the audited financial statements.

### Outcome of audit procedures

The auditor's report is required to include a statement on how a KAM was addressed. It is permitted but not required that the auditors provide an indication of the outcome of the auditor's response. The auditing standards preclude auditors from providing discrete opinion on separate elements of the financial statements.

### Presentation of KAM

KAM should be presented as a separate section after the basis for opinion section of an auditor's report.

- In case KAMs identified relates to a modification, a statement to this effect is to be included under the KAM heading.
- In case, 'material uncertainty relating to going concern' section is required as per revised SLAuS570, then KAM section is placed after that section.
- Based on the auditor's judgment 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.

## Summary of modifications in the Auditor's Report

Non-Standard reports	KPMG	E&Y	PWC	Deloitte	Others	Total
Material uncertainly relating to going concern	2	2	-	-	4	8
Emphasis of matter	7	4	-	-	5	16
Other matter	-	1	-	-	1	2
Qualification	4	3	-	2	4	13

## Emphasis of Matter

Emphasis of matter (EOM) paragraphs are still used, but are now much less common. Examples of the matters now reported under the heading of EOM include "Restatement of previously issued financial statement due to errors."

For listed issuers, the most common matter previously reported under the heading of EOM was related to going concern. This is now reported under the heading of "Material uncertainty related to going concern".

Where a matter meets the definition of a KAM and an "Emphasis of matter and/or other matter", it will be reported as a KAM. This approach allows the auditors to include additional information in the description of the KAM.

### Illustration of EOM



We draw attention to Note xxx of the financial statements wherein the Group has considered all land held and used in business as Investment Assets. Based on our understanding of the Inland Revenue Act and legal advice provided by the expert, there is significant judgment involved in determining whether the lands held by the entity and used in business are to be considered as capital assets or investment assets due to the uncertainties that exist with respect to the interpretation of the application. In the event the Group's position is not held by the Authorities, the impact on the Company and Group is disclosed in Note xxxx to the financial statements. Our opinion is not modified in respect of this matter.



## Analysis by Audit firm

The new auditors reports are specific to the organization being audited, which means there is now less consistency between auditors reports. The analysis shows that there is no standard length, and no “correct “ number of KAMs.

For the financial year 2018 there were 280 audited financial statements which were issued and published. Out of **280** financial statements **106** audited financial statements were issued by KPMG Sri Lanka.

Length of the auditors report	KPMG	EY	PWC	Deloitte	Other firms	Total average
Average page numbers – New	4	3	3	3	3	3
Average page number – Old	1	1	1	1	1	1

Number of KAMs reported	KPMG	EY	PWC	Deloitte	Other firms
Average number of KAMs	3	2	2	1	1
Highest number of KAMs	8	5	3	2	5
Lowest number of KAMs	1	1	1	1	1

A general concern noted in the Sri Lankan context is a low number of KAMs in large conglomerates involved in diversified business and also companies in financial service business. Further, the narrative explanations in the local report are generally, brief, and therefore the length of the audit reports are also shorter. This may not provide adequate transparency of the most important audit matters discussed between the auditor and the audit committee.

## Reporting Of KAMs

Bank, finance and insurance

101



Hotels and Travels

67



Manufacturing

62



Beverage, food and tobacco

35



Plantation

38



Others

207



# KAMs by sector for the year 2018



Banking,  
Finance and  
Insurance



Beverage, food  
and tobacco



Chemical and  
Pharmaceutical



Construction  
and  
Engineering



Diversified  
Holdings



Footwear and  
Textiles



Healthcare



Hotels and  
Travels



Information  
Technology

<i>No. of entities</i>	64	22	8	4	17	2	6	37	1
<i>Capital WIP</i>	-	-	-	-	-	-	-	-	-
<i>Valuation of IP</i>	5	1	1	1	6	-	-	4	-
<i>Business Combinations</i>	-	1	-	-	3	-	-	-	-
<i>Impairment of Goodwill</i>	2	3	1	1	6	-	-	7	-
<i>Impairment of Financial Instruments</i>	44	6	5	2	8	-	2	5	-
<i>Equity Accounting</i>	1	-	-	-	-	-	-	2	-
<i>Provision and Contingent Liabilities</i>	-	1	-	-	1	-	2	-	-
<i>Revenue Recognition</i>	4	4	-	-	-	-	6	2	1
<i>Valuation of Financial Instruments</i>	1	-	1	-	1	-	-	3	-
<i>Going Concern</i>	-	-	-	1	-	-	1	3	-
<i>Investment in Subsidiaries</i>	2	6	3	2	6	-	-	6	-
<i>PPE</i>	1	6	1	-	7	1	2	24	-
<i>Held for sale and discontinued operations</i>	-	-	1	-	-	-	-	-	-
<i>Valuation of Retirement benefits</i>	1	-	-	-	-	-	-	-	-
<i>RPT</i>	-	-	-	-	1	-	1	3	-
<i>IT</i>	10	-	-	-	-	-	-	-	-
<i>Biological assets</i>	-	3	-	1	7	-	-	-	-
<i>Inventory</i>	-	3	4	1	3	2	2	-	-
<i>Deferred Tax</i>	8	1	-	1	3	-	-	7	-
<i>Insurance Liabilities</i>	14	-	-	-	2	-	-	-	-
<i>Other</i>	8	-	-	-	3	-	1	1	-
<b>TOTAL</b>	101	35	17	10	57	3	17	67	1



Investment Trust

Land and Property

Manufacturing

Motors

Oils Palms

Plantation

Power energy

Service

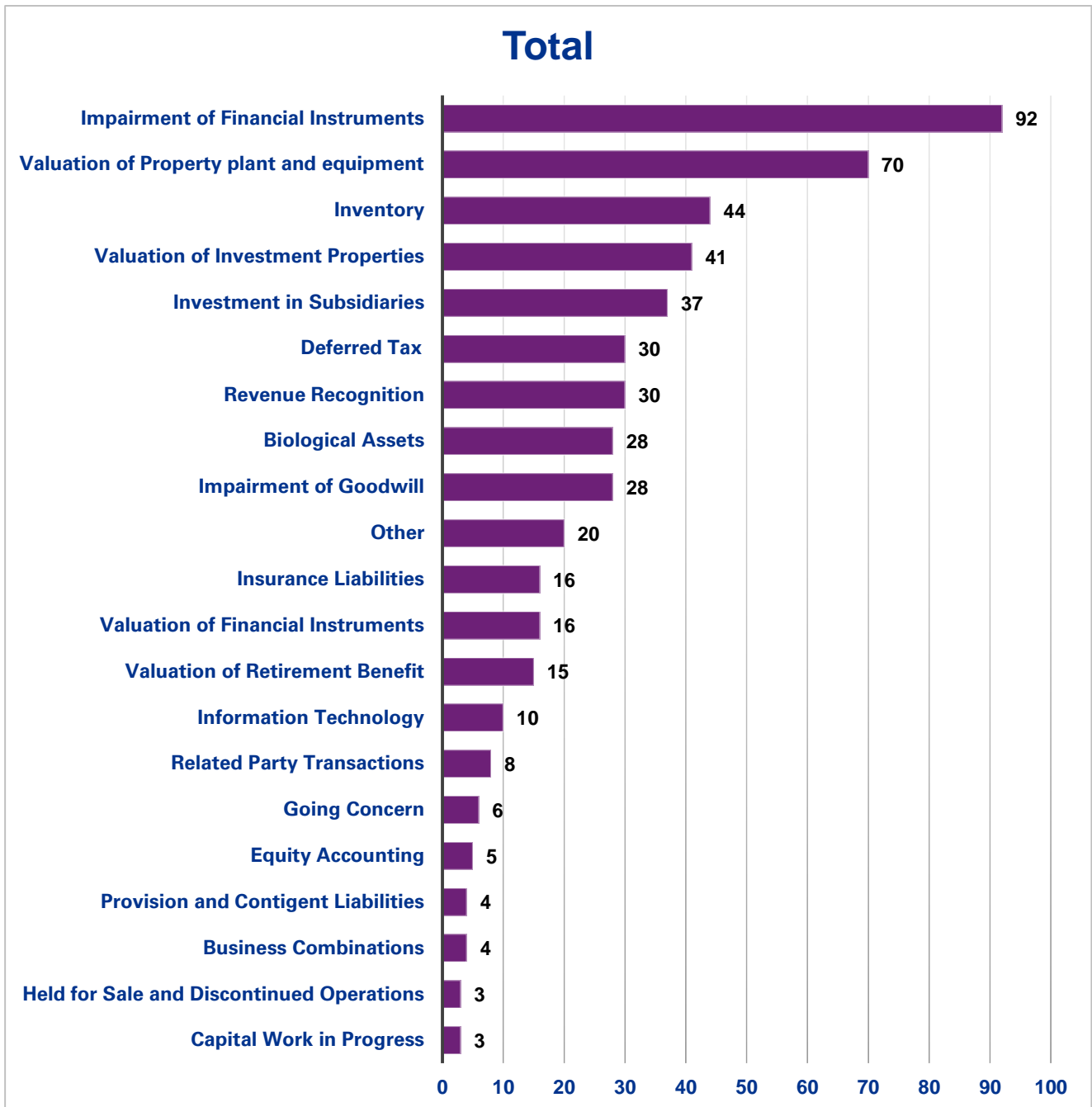
Store Suppliers

Telecommunication

Trading

Total

9	17	33	6	5	19	9	8	4	2	7	280
-	-	2	-	-	-	-	-	-	1	-	3
2	10	6	-	-	-	-	2	1	-	2	41
-	-	-	-	-	-	-	-	-	-	-	4
2	-	2	-	1	-	2	-	-	1	-	28
1	1	5	3	1	-	2	4	1	-	2	92
-	-	-	-	-	-	1	1	-	-	-	5
-	-	-	-	-	-	-	-	-	-	-	4
-	2	4	3	-	-	1	-	-	2	1	30
3	1	-	1	4	-	-	-	1	-	-	16
-	-	1	-	-	-	-	-	-	-	-	6
1	3	-	1	-	1	2	2	1	-	1	37
3	1	15	2	-	3	1	-	1	1	1	70
-	-	1	-	-	-	-	-	-	-	1	3
-	-	-	-	-	14	-	-	-	-	-	15
-	2	1	-	-	-	-	-	-	-	-	8
-	-	-	-	-	-	-	-	-	-	-	10
-	-	2	-	-	14	-	-	-	-	1	28
1	2	18	4	1	-	-	-	1	-	2	44
-	1	1	-	-	5	-	-	1	-	2	30
-	-	-	-	-	-	-	-	-	-	-	16
-	-	4	1	-	1	1	-	-	-	-	20
13	23	62	15	7	38	10	9	7	5	13	510



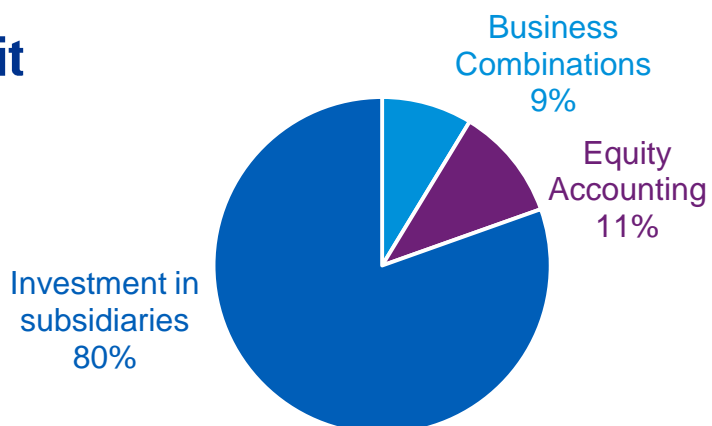
The most common KAMs reported are as we expected given the structure of the Sri Lanka market; Impairment of financial instruments, valuation of PPE, inventory and valuation of investment property. Other common KAMs such as investment in subsidiaries and deferred tax are linked to industry specific developments.

- Impairment of financial instruments is the most common KAM in the commercial property sector. This is largely due to the judgment and assumptions involved in the valuation of financial instruments, and the significance of the assets in the entity's balance sheet.
- Valuation of PPE is mainly seen in the hotel and travel sector, which is a growing sector in Sri Lanka. Due to reliance on tourism.

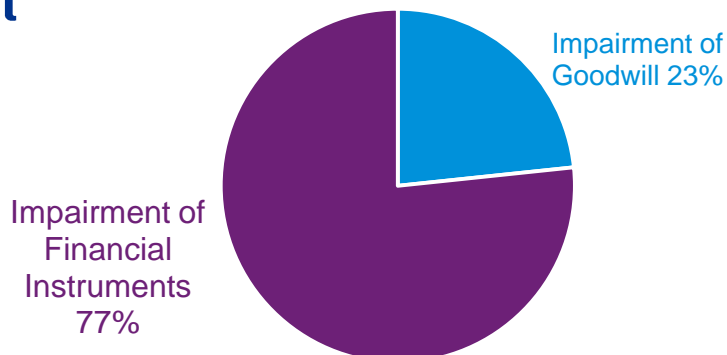
# KAMs by Subcategories

For some of the main KAM categories, We have gone further and identified the following main recurring subcategories of KAMs, as presented in the charts below. However, we note that for some of the main KAM categories, we did not observe notable subcategories.

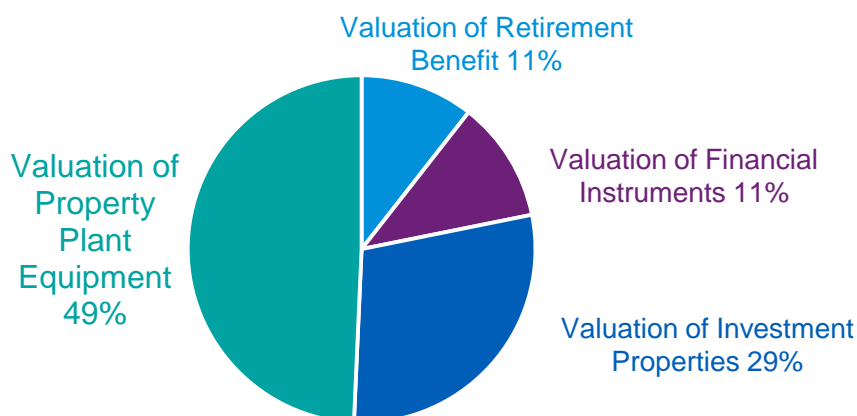
## Group Audit



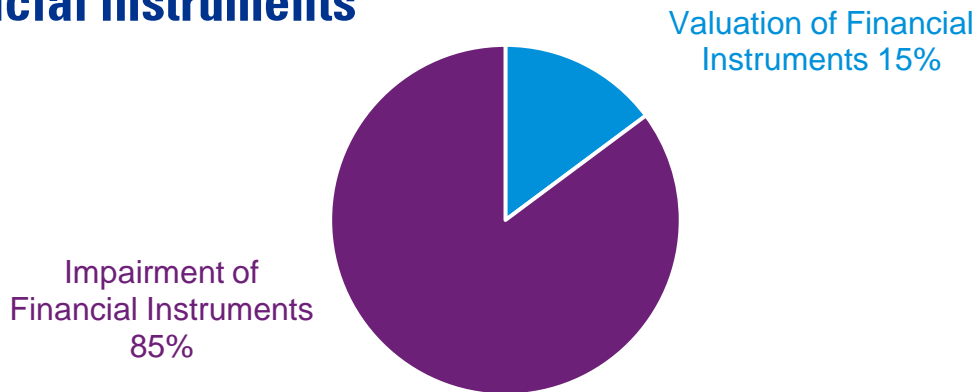
## Impairment



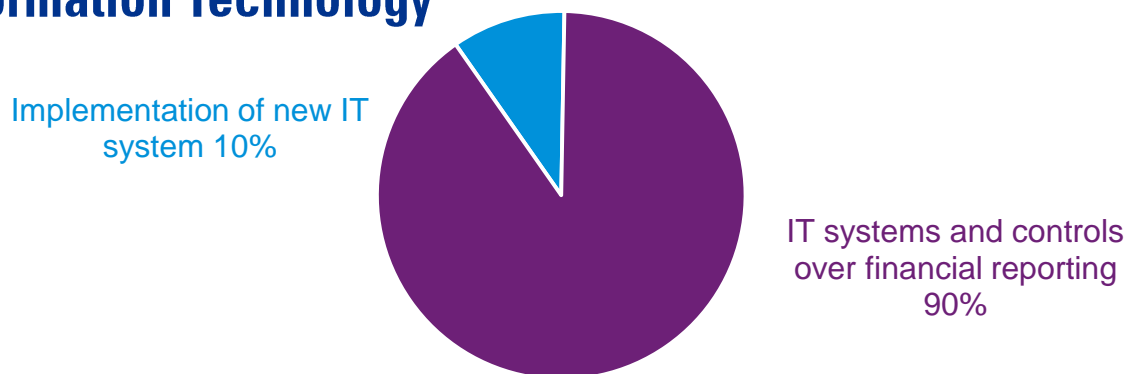
## Valuation



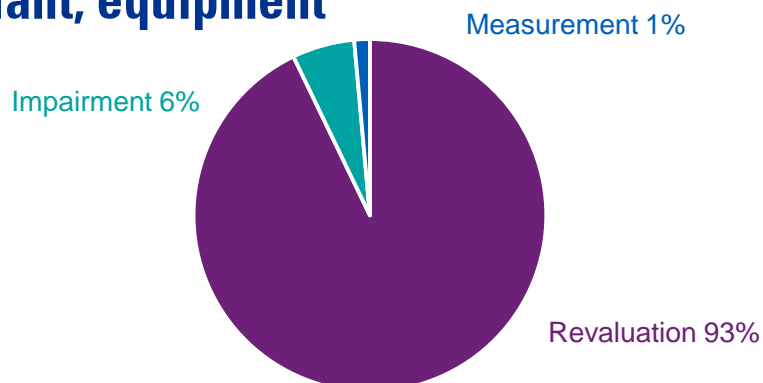
## Financial instruments



## Information Technology



## Property, plant, equipment





# Illustration of KAMs

## Carrying value of Inventory

### Risk Description

Refer to Note xx (accounting policy), Note xx to these Financial Statements.

The Group has recognized a total inventory provision of Rs. XX million in arriving at a total inventory value of Rs. XX million

The Group has significant levels of inventories and significant management judgments are taken with regard to categorization of inventories into obsolete and/or slow moving and which should be therefore be considered for provision. Estimates are then involved in arriving at provisions against cost in respect of slow moving and obsolete inventories to arrive at valuation based on lower of cost and net realizable value.

Given the level of significant management judgments and estimates involved this is considered to be a key audit matter.

### Our Response

Our audit procedures included:

- Challenging the management with regard to the calculation methodology, the basis for provision and the process with respect to inventory provision.
- Testing the design, implementation and operating effectiveness of the key controls management has established for provision computations and to ensure the accuracy of the inventory provision.
- Assessing the adequacy of, and movements in, inventory provisions held, by recalculating a sample of items included within the provision to ensure appropriate basis of valuation.
- Evaluating, on a sample basis, whether inventories were stated at the lower of cost or net realizable value at the reporting date by comparing the sales prices of inventories subsequent to the reporting date.
- Evaluating the appropriateness of the assumptions used based on our knowledge and information of the client and the industry.

## IT systems and controls over financial reporting

### Risk Description

The Company's key financial accounting and reporting processes are highly dependent on the automated controls over the Company's information systems. As such that there exist a risk that gaps in the IT control environment, including automated accounting procedures, IT dependent manual controls and controls preventing unauthorized access to systems and data could result in the financial accounting and reporting records being materially misstated. The IT systems and controls, as they impact the financial recording and reporting of transactions, is a key audit matter and our audit approach could significantly differ depending on the effective operation of the Group's IT controls

### Our Response

We used our internal IT specialists to perform audit procedures to assess IT systems and controls over financial reporting, which included the following:

- General IT controls design, observation and operation
- Testing the sample of key controls operating over the information technology in relation to financial accounting and reporting systems, including system access and system change management , program development and computer operations.
- User access controls operation
- Assessing the management's evaluation of access rights granted to applicants relevant to financial accounting and reporting systems and tested resolution of a sample of exceptions.
  - Assessing the operating effectiveness of controls over granting, removal and appropriateness of access rights.
  - Testing of specific application controls for key financial reporting controls.

# The future at your fingertips



*77% of CEOs are concerned about whether their organization is keeping up with new technologies.*

Source: 2016 Global CEO Outlook, KPMG International.

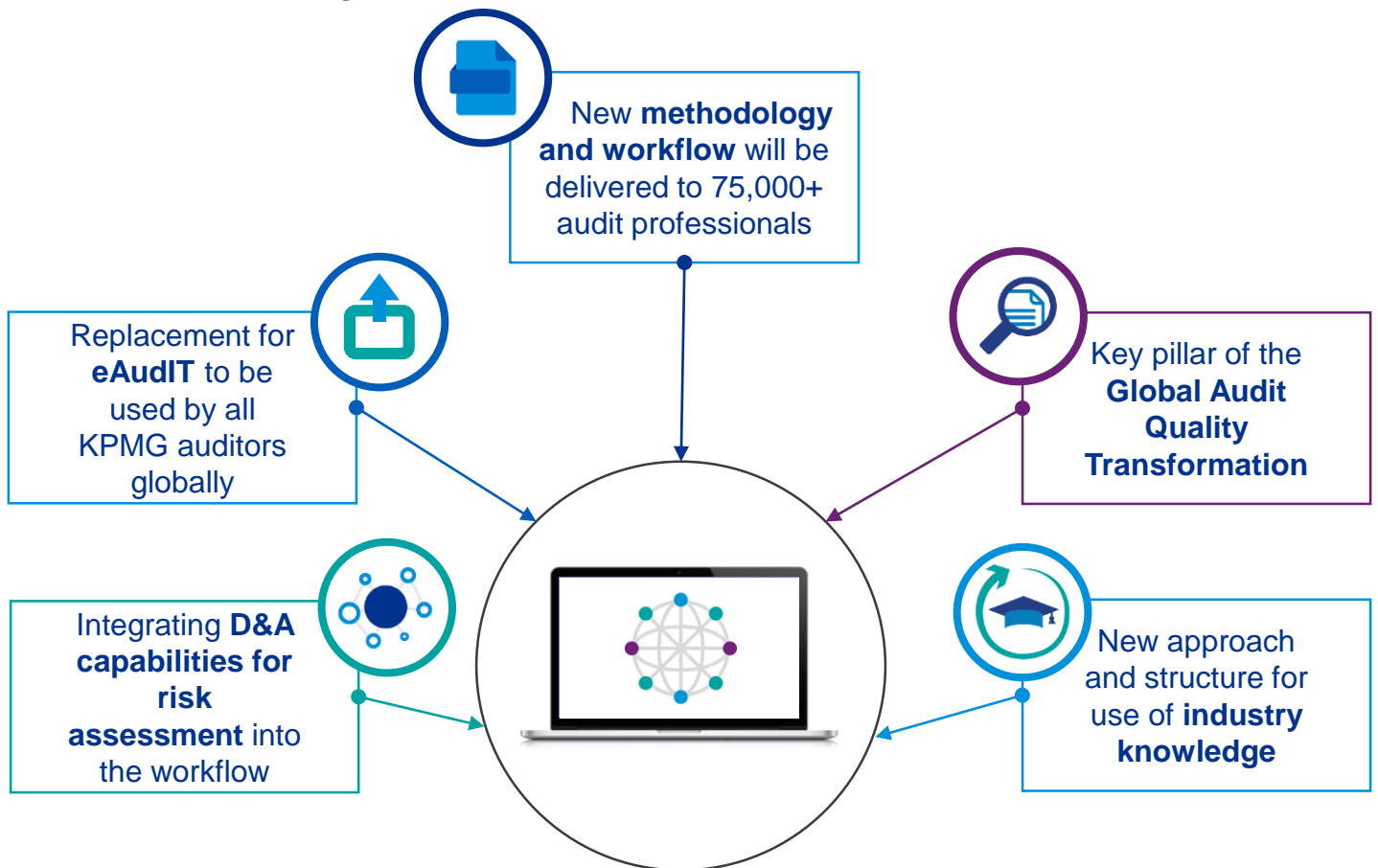
**Technology and data are changing how all of us work. This has significant impact on how we access and use data: investors to inform their decisions, auditors to inform their judgment and skepticism, and corporations and their governance bodies to run and oversee their business. Ever more sophisticated tools are leading to an explosion of data. Making sense of this, and accessing the value of it, is the challenge that leaders face across industries.**

**KPMG's Dynamic Audit can illuminate the situation** KPMG has been investing significantly in evolving audit capabilities in recent years — a global electronic audit workflow, and advanced capabilities leveraging data, automation, and visualization. We live in an interconnected world where data moves faster than the speed of thought. D&A is integral to KPMG member firms' offerings — the way they obtain audit evidence and interact with clients in the digital era. The time has come for us to unify our proven innovations into one powerful, intelligent platform — a platform that is agile, scalable and ready to integrate future innovations, like cognitive and artificial intelligence.

**Meet KPMG Clara** - KPMG Clara is the next era in our evolving dynamic audit. An intelligent platform rooted in KPMG’s audit methodology and international auditing standards, it allows our people to work smarter, driving enhanced audit quality through expanded analytics capabilities. Through alliances with some of the world’s most advanced technology companies — Microsoft, IBM Watson to date — we are building the future of audit, aligning with technology leaders to bring new insights faster and, with growing capabilities, deliver even more value through KPMG member firm audits.

**Audit’s elegance is in the details** - In today’s world, our lives are enriched by increasingly connected and collaborative experiences. Now, your audit is too. For you, KPMG Clara will become your digital connection to KPMG firms, providing one coherent, interconnected ecosystem. It’s a collaborative and interactive environment in which two-way and interactive communication between you and the audit team is hugely enhanced. Giving you greater visibility into your audit, and access to deeper levels of information, it offers a new and richer experience. Through KPMG Clara, member firms can provide powerful insights into your business that you may not have known were possible, and give them to you on a real-time basis as the start of a focused, meaningful discussion — driving a better quality audit. KPMG Clara can unleash the potential of your data by helping you see meaningful patterns across business units and geographies, and at a deeper level than before, giving you a more holistic view of your customer and competitive environment.

**An automated, agile, intelligent and scalable technology, KPMG Clara allows you to interact with KPMG firms online, on a real-time basis as we conduct the audit, bringing you greater and more relevant insights.**



Delivered through KPMG Clara Smart Audit Platform

# Acknowledgement

The following KPMG Staff have made significant contribution towards the development of this publication



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# Audit Leadership Team

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**Yohan Perera**



**Suren Rajakarier**



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**Chamara Abeyrathne**



**Upul Karunaratne**



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**Chameeri Ihalagamage**



**Pyumi Sumanasekara**





# About KPMG

## KPMG Global

KPMG is one of the world's top global networks of professional services firms. We provide, audit, tax and advisory services with quality, integrity and excellence as fundamental pillars that have marked our work over our more than 140 years of history.



Global Revenue

28,960 million USD



Revenue figures 2017/2018



153  
Countries



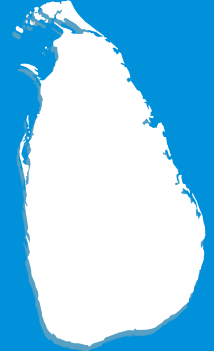
985+  
Offices



207,050  
Professionals

## KPMG Sri Lanka

KPMG is one of the largest professional services firms in Sri Lanka and is also the oldest Chartered Accountancy firm in the country spanning over a century since inception in 1897.



**6 Offices**

Including one in Maldives



**Over 1,400 Professionals**

Our clients value the breadth of skills and experience KPMG professionals bring to every client engagement



**Audited 45% of Listed Entities in Sri Lanka**

As indicated in the LMD Auditors League 2016.

683

Professionals in  
**Audit**



178

Professionals in  
**Tax**



272

Professionals in  
**Advisory**

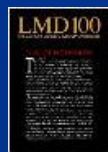


## Recognition | KPMG in Sri Lanka



First in the Financial Services Category

LMD Most Respected 2019



First in the Auditors League in Sri Lanka

LMD 100 - 2017



Sri Lanka Tax Firm of the Year

Asia Tax Awards 2017



Best Advisory Firm in Sri Lanka

The International Finance Magazine 2016



Best Deal Advisory Firm in Sri Lanka

Global Banking and Finance Review 2015

Highlighting the significance of KPMG's impact in the marketplace, KPMG in Sri Lanka received a number of accolades including being the 'Best Deal Advisory Firm in Sri Lanka' by The Global Banking and Finance Review for its outstanding achievements in Deal Advisory, being ranked among the 'Most Respected' entities in the country for 2019 and being ranked first in the 2015/2016 Auditors League as indicated in the LMD 100. The firm also won the Tax Firm of the Year at the Asia Tax Awards 2017.



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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