Stakeholders see value in enhanced auditor's report

Participants at a recent KPMG Singapore roundtable discuss how changes can help boost public trust in auditors. BY KENNETH LIM

PROFOUND changes to the auditor's report have arrived, with the implementation this year of new standards aimed at enhancing the traditionally dry and technical document.

Market stakeholders and professionals at a recent roundtable organised by KPMG in Singapore reflected on the new enhanced auditor's report requirements, sharing their hopes that the new format will improve understanding of the audit process and provide a basis for improved shareholder engagement. But they also voiced concerns about a retreat to boilerplate outcomes if the spirit of the new rules fail to take hold.

"It's a long time in coming, and I would say it's maybe only the start," said Lee Chong Kwee, chairman of Mapletree Logistics Trust Management. "If you look at those charged with governance, it's useful, but if you look at the investing public, it's even more useful."

The enhanced auditor's report standards that were announced by the International Auditing and Assurance Standards Board in 2015 came into effect in Singapore this year for companies whose fiscal years end on or after Dec 15, 2016.

The most visible change lies in the introduction of "key audit matters", a distinct section in which the auditor is expected to discuss matters that required extra attention during the audit. Beyond that, the new guidelines also shift more responsibility to auditors to step up testing and disclosures when significant going-concern issues arise.

Those changes came about partly to address concerns about declining levels of public trust in auditors. As Aberdeen Asset Management Asia head of corporate governance David Smith said: "Over the last 20 years there's essentially been a deterioration in the level of trust between stakeholders in capital markets, whether it's the level of trust the public has in companies and investors who are managing their money, or the level of trust between investors and companies, or the level of trust between investors and auditors."

The roundtable panellists were unanimous in their support for the new reporting standards. One of the biggest benefits identified at the roundtable was the opportunity for auditors to shed more light on the issues facing the company's financial statements.

Gautam Banerjee, chairman of Blackstone Singapore and director on a number of listed and private companies, said that the new reports can help to improve understanding of the many judgment calls that auditors and management have to make in preparing the company's financial statements.

"The audit report has been, up until now, a pass or fail thing," he said. "No one really looks at it unless there's something which is unusual, which actually doesn't do justice to a very significant process that takes place with a lot of time spent by external auditors, by the firm's financial group and by independent directors. And you have nothing to show for it, there's just the audit report."

He added: "It's firstly a very positive development because it gets everyone to understand. It takes some of the mystery out of what actually the auditors do, and what audit committees do, and how finally the opinion is arrived at, and I think the educational impact of this whole process cannot be underestimated.

"Whenever there's something that goes wrong – there's a financial crisis or a company collapses – there's this huge difference in expectation. Oh, what happened? Why didn't the auditors focus on it and get it right? And I think this whole approach and reporting makes it very clear to everyone that an external audit is not a precise stance. It is based on judgments, it is based on a lot of things being discussed and evaluated."

Having that flexibility to discuss issues in a qualitative manner can give investors a better sense of the risks and uncertainties surrounding a business, Singapore Exchange head of listing compliance June Sim said.

"In the past when you look at annual reports of listed companies, if you have a disclaimer of opinion or emphasis of matters, then investors have a rude shock in terms of the developments in the company," she said. "But now with key audit matters being disclosed, it's the basis for

Mr Ramsay of KPMG Singapore, who shared his company's study of annual reports, says accountants are not traditionally known for being good communicators.

conversations between boards as well as institutional and retail investors. So I look at key audit matters as no different from the risk factors that you see in an initial public offering prospectus, because companies don't fold overnight. You don't have disclaimers of opinion overnight."

The process of coming up with the reports can also help management and board directors to understand and address matters that are relevant to the business.

Mr Banerjee, who heads Singapore Airlines' (SIA) audit committee, said: "For me as a chairman of an audit committee, it was particularly helpful. . . Like all audit committee members, we, I think, carry a little bit of an additional burden. Most of the other board members feel, 'Oh, it's audit, it's your problem, you sort it out.' And I think this gives a very formalised and systematic way of making sure that all my other board members know what the issues are."

The process is still evolving, however. KPMG Singapore audit partner Malcolm Ramsay shared his firm's study of annual reports in Singapore, London, Hong Kong and Australia, and found that reports in London tended to mention more key audit matters than in the other three markets.

Mapletree's Mr Lee said: "I'm a bit perplexed why there are not more key audit matters, because if you look at the challenges a company faces, there are many more issues, so the matters of key audit matters cannot be just on, for example, valuation. What about the other issues? I would say that the acid test will come – hopefully it does not happen – but if you could take historical examples as a point in case, if something goes wrong and the company goes under for reasons 3, 4, and 5, and 3, 4, and 5 were never listed for multiple years, then of course I think the auditors have nowhere to hide. In addition to, of course, those charged with governance. So I hope this is just the start of the process."

Quality matters

But panellists also cautioned against reducing the reports into a numbers game, stressing that it was not the number of key audit matters reported that matters, but the quality of the reporting.

One challenge noted was figuring out what should go into an enhanced report. A number of panellists expressed a desire for auditors to look beyond the obvious financial matters and to consider sustainability and resilience issues in the context of the matters of the day.

Mr Banerjee opined that "key audit matters should move up the scale to focus on more strategic, sustainability and going concern type of issues, which at the moment I don't think that it's doing".

Mr Smith said there was a broad trend among investors to seek more than just financial information.

"What we're looking forward to is more commentary rather than processes and governance," Mr Smith said. "Even if you look at non-performing loans or certain sector exposures in banks, you'll see language potentially around, 'We were satisfied with our classification', but I think what we will always be looking for is commentary around how the process through which this decision was reached."

He added: "For us, it has always been skewed towards the non-financial. Things like strategy and execution, sustainability, governance, management, bench strength, compensation, and then financials, because I think it's almost impossible now to go into a meeting and discuss with a CFO just on financials. We want to know everything around a group."

Whether that kind of information can actually be provided in a meaningful way, however, will take some work, KPMG Singapore audit partner Malcolm Ramsay said.

"It is an expectation gap as well," Mr Ramsay said. "There's a discussion about business models. Typically it's the livelihood of the company until the next report, which is the focus, even though evaluations are multi-year. How do you get to business models when you're really trying to look at a 12-month cycle? I agree fundamentally, it's just the 'how' that gets difficult. As we get to these more subjective areas, they're very difficult conversations to have with clients as well. It's great when things are going great, but if your business model is under significant pressure, they're very difficult conversations to have and then document."

Yap Chee Keong, a veteran director who sits on a number of boards and audit committee, said companies and auditors will need to learn how to communicate the issues.

"The art is how do you communicate enough to let the people know these are the challenges, but don't worry, your board has understood the issues, dealt with them and the auditors agree," he said. "Take the example of goodwill or fair value. We have to use models that are forward looking 10 or 20 years. So on one hand you want to communicate that there's uncertainty, there's sensitivity et cetera. But at the same time you can't put forward-looking statements that could be tantamount to a forecast. Then how do you communicate that there are uncertainties, there are sensitivities, but we did apply our minds to it?"

As Mr Ramsay put it, accountants are not traditionally known for being good communicators.

"I've been doing this for 25 years, and it is a breath of fresh air as a profession, in terms of being able to express itself," Mr Ramsay said. "But as was mentioned earlier, we're probably accountants because we're good with numbers, not because we're good at creative writing or the written word. So how do you express that in a way that doesn't generate noise around, oh lord, is it saying something that's a problem? That it's valuable, but we're not saying a blanket everything is fine."

But there is no getting around the challenge, said Olam International chief financial officer Neelamani Muthukumar.

He shared that while his company already has robust systems in place to meet the demands of its institutional investors, it had to do more to satisfy the enhanced reporting requirements. In particular, the company must now ensure that it can support the numbers that would typically go in the strategy section of an annual report.

"Those statistics which historically we used to put in our strategy section, now are being verified by the auditors because the 'Other information' section actually talks about auditors having to concur with all these numbers that are being put in other sections of the annual report. Hitherto, they were never looking at it. They were only bothered about the financial statements," Mr Muthukumar said.

"That is where we were hit hard. We looked at it six months ahead of time, we called our corporate communications team, we pulled our sustainability team, we pulled our business teams, and then said, OK, whatever information we are now going to put in our annual report is going to be verified by our auditors, and we need data trails. And we need a system to verify these data, so that we don't scramble at the last moment and say, hey, this information we are not comfortable with and they have to qualify that."

But he said that it was overall time well spent. "It also gives me as a CFO a more holistic understanding of what types of numbers are being pulled up. . . It sharpens our focus, it helps me."

Notwithstanding the benefits that companies can reap from going through the enhanced reporting process, the concern was that the additional burden might cause some pain and resistance among smaller companies. As Mr Banerjee put it: "This is also an exercise not for the top 20 or 30 companies on the exchange. It's a big exercise to bring standards up for the 600 or 700 or so guys, where there are real issues about are these guys coming to the table, are they doing a proper job? It's a smaller firm of auditors who probably only have five listed companies or one listed company, so I think this is also an exercise for everyone to improve."

Mr Lee, who noted that enhanced reporting "did not voluntarily arise from the auditing industry" but was "thrust upon them", said the risk is higher that smaller companies will turn to convenient templates to comply instead of following the spirit of the new standards.

"The tendency to become a boilerplate is very strong," Mr Lee said. "At the end of it, you issue an unqualified report but then you got to list out key audit matters. So you have to be very careful what you say so that people don't ask, hey, why is it an unqualified report? I think auditors will be very careful. Many audit committees and management will actually be working in tandem to make sure you don't raise any more questions. Hence the tendency to get watered down."

The test will come in the next few years, when companies' second and third reports will reveal the extent of boilerplate reporting, not just in terms of language, but also in terms of issues highlighted.

Mr Smith said: "What will be important to see over the next few years is how enhanced auditors' reports evolve over time in Singapore, particularly when there's been a change in treatment for example or when people get more comfortable with these. I think there's maybe been a little bit of timidity with some EARs as everyone gets out of the starting blocks this year. I think we've seen some punchier enhanced auditors' reports in the UK."

Investors will play an important role in fighting back against boilerplate reporting, Mr Smith said.

"What will be important will be the dialogue between boards and investors to improve enhanced auditors' reports. . . Now we have dialogue with management, management has dialogue with the board, board has dialogue with the auditors, and I think closing that link, having investor dialogue with the board, will make the ecosystem stronger, and I think that's something that's been missing so far."

For the smaller companies as well, feedback will hopefully incentivise them to raise their game.

"Who's using these KAMs? Certainly if they're smaller companies, they're not covered by the buy side or sell side, and if retail is not looking at these KAMs in detail, then they'll very quickly slip into boilerplate, one or two disclosures, and I think that's where we've got a real challenge. Who's picking up on these disclosures?" Mr Smith said.

Watch highlights of the KPMG roundtable on Key Audit Matters here: http://bt.sg/kpmgkam

Assessing the enhanced auditor's report

Take a look at the annual report of a Singapore-listed company this year, and one will find a new format in the external auditor's report. Under guidelines that took effect for fiscal years that end on or after Dec 15, 2016, the external auditor's report is now "enhanced" with a number of changes aimed at making the report more informative and less reliant on boilerplate language.

What is new in the enhanced auditor's report?

For listed companies:

- A new section to communicate "key audit matters"
- Disclosure of the name of the engagement partner

For all audits:

- Opinion section to be presented before the basis for opinion
- Increased reporting on going-concern assumptions
  - *Description of responsibilities of management and auditor for going concern*
  - *Separate section if a material uncertainty exists on going concern*
  - *Auditor must challenge the adequacy of disclosures for "close calls"*
- Affirmative statement about auditor's independence and fulfillment of ethical responsibilities
- Better description of auditor's responsibilities

What are key audit matters?

Matters that were the most significant during the audit and that required significant auditor attention.

Matters that could be considered include:

- Areas of higher assessed risks of material misstatement
- Areas that required significant judgement by the auditor and management, including estimates with high levels of uncertainty
- Effect on audit of significant events or transactions that occurred during the year

What key audit matters are not:

- A modified or piecemeal audit opinion
- A substitute for financial statement disclosures

Progress so far

A survey across four markets by KPMG found that carrying-value assumptions and revenue-recognition policies were among the most commonly highlighted issues by external auditors as key audit matters.

Industry sector's share of reports surveyed (%)	Singapore	London	Hong Kong	Australia
Real estate	18.7	7.5	17.3	11.4
Manufacturing	14.9	6.7	8.3	1.4
Construction & engineering	11.2	3.6	3.2	7.1
Electronics	8.5	2.8	10.9	1.4
Energy & natural resources	8.0	4.0	6.4	25.7
Shipping, transport & logistics	6.5	5.2	3.8	2.9
F&B	5.7	7.1	3.2	1.4
Consumer	4.0	4.0	8.3	1.4
Banking & financial services	3.5	2.4	9.0	12.9
Healthcare	3.0	2.4	3.2	1.4
Others	16.2	54.4	26.3	32.9

Percentage of reports that highlighted each risk type as a key audit matter (%)

	Singapore	London	Hong Kong	Australia
Receivables & allowances	**34**	16	**42**	11
Property, plant & equipment impairment	32	17	17	26
Inventories	30	25	22	0
Revenue (non-fraud related)	25	**51**	29	30
Goodwill	22	35	18	**33**
Investment properties	17	6	19	10
Investment in subsidiary, associate and JV	16	6	6	6
Acquisitions	11	11	9	16
Intangible assets	8	21	6	4
Provisions & accruals	4	21	4	17

Sources: International Auditing and Assurance Standards Board, KPMG