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Our ref ED Submission Auditor Reporting

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Dear Merran

***AUASB Exposure Draft, Reporting on Audited Financial Reports - New and Revised Auditor Reporting Standards and Related Conforming Amendments***

We are pleased to have the opportunity to respond to Exposure Draft, Reporting on Audited Financial Reports - New and Revised Auditor Reporting Standards and Related Conforming Amendments (the exposure draft) issued by the Auditing and Assurance Standards Board (AUASB). This letter represents the views of KPMG Australia.

**Overarching comments**

Overall, KPMG Australia supports the initiatives to enhance the transparency of auditor reporting through the introduction of a new standard (proposed ASA 701) and the amendments to other existing standards. However, we would like to highlight the following three areas:

***Going concern***

We have concern that the difference in level and nature of descriptions between a Material Uncertainty Related to Going Concern and a Key Audit Matter ('KAM') may mislead users of the auditor's report on the financial report.

Where a material uncertainty exists: The proposed wording of the Material Uncertainty Related to Going Concern paragraph provided in proposed standard ASA 570 *Going Concern* references to the financial report disclosures regarding the conditions relevant to the client's consideration for using the going concern basis of preparation, and also identifies that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern. When the issue of going concern is also a matter of audit significance (as is likely to be the case), there is no further elaboration or description of audit effort or audit procedures provided in the audit report..

Where a material uncertainty does not exist: In cases where going concern is determined to be one of the most significant matters in the audit, the proposed wording of the Key Audit Matter includes references to the financial report disclosures, explains why going concern was

considered most significant in the conduct of the audit, and how going concern was addressed in the audit. Accordingly, the level of description by the auditor regarding going concern is far more extensive when there is no material uncertainty, than if there is. **This seems to be counter-intuitive and we consider this may mislead users that a going concern “close call” is more important than where a material uncertainty exists.** We recommend the AUASB consider addressing this imbalance.

A further complication with going concern “close calls” as key audit matters is in circumstances where the client has minimal or no disclosures in the financial report describing their conditions and considerations in using the going concern basis of preparation. It is likely that the auditor will be faced with assessing whether their descriptions will originate client information in the audit report. The accounting standards do not require going concern disclosures unless a material uncertainty exists.

*AASB101.25 When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties.*

We recommend the proposed auditing standards provide guidance for these scenarios.

### ***Interaction of Emphasis of Matter paragraphs to Key Audit Matters***

We have concern with ASA 701.8(b) and related guidance that appear to preclude the auditor raising an “amber alert”, i.e., an emphasis of matter, to reference the financial report for a matter of fundamental importance to a user’s *understanding of the financial report*, where the issue was also a KAM, i.e., one of the most significant in the *conduct of the audit*. Instead the auditing standard suggests the issue only be described as a key audit matter, which may be one of several matters disclosed, not providing sufficient gravity, weight or prominence to the matter.

We do not consider a Key Audit Matter to be a substitute or equivalent to an Emphasis of Matter, both having differing purposes. In our experience certain matters of significance in the conduct of the audit, are matters that have direct relevance to users of the **financial report** in *understanding the financial position and performance of the entity*. These should be highlighted separately to distinguish them as fundamental to the reading and utility of the **financial report**, rather than the reading and understanding of the audit conducted and the opinion expressed in the **audit report**.

To illustrate: where the auditor determines a key audit matter is the costs to complete of a particular large scale construction project, draft ASA 706.8 would preclude the auditor from highlighting certain observations on this project as an emphasis of matter. However we have seen situations where due to a particular catastrophic event occurring at the construction (generally close to year end), the costs to complete were so significant, uncertain and with the lack of time incapable of reliable assessment, it was determined that an amber alert, (EOM), was required to draw the reader of the financial reports attention to the issue as being *fundamental to their understanding of the client’s financial position*. In this situation, draft

ASA 706.8 would have the issue described as one of several key audit conduct matters arguably without sufficient gravity given to the impact on the financial report.

A further illustration is where an entity relies on a license/patent to sell their product. We have seen situations where the legitimacy of the authority to conduct their business has been questioned, either through dispute, legal case or due to concerns over the correct registering procedures. Where the audit effort involved gives rise to the matter meeting the definition of a KAM, the issue would be precluded from also being an EOM. In these circumstances, where the underlying business model is dependent on the successful resolution of the dispute, it is fundamental to users of the financial report to understand this uncertainty in making their economic decisions. We consider this to need the gravity of an emphasis of matter rather than being diluted in the description of several key audit matters.

We also remain concerned with the inconsistency with non-listed entities. An issue may be a KAM in a listed entity, whereas the same or similar issue may be an Emphasis of Matter in a non-listed entity due to the proposed application of KAMs only being to listed entities.

We recommend the AUASB repeal ASA 701.8(b) to allow the auditor to use judgement to determine a matter should be an EOM and prominently highlight the critical importance of the matter to the reader of the financial report, rather than prohibiting the auditor to raise an EOM and potentially lose the importance of the matter within multiple audit conduct (KAM) descriptions. In the absence of endorsing a full repeal of ASA 701.8(b), the AUASB may consider (1) softening the prohibition such that auditor judgement can be exercised, or (2) insertion of specific language in the KAM to draw users attention to the matter as *fundamental to their reading/understanding the financial position and performance of the entity*, which is over and above the KAM intent of additional *understanding of the conduct of the audit*.

### ***Auditor's responsibilities description***

We strongly support the proposal to relocate the description of the auditor's responsibilities required by paras 38-39 of ASA 700 to a website of an appropriate authority to allow the greatest flexibility to auditors to simplify the report and promote the importance of the key audit matter paragraphs.

### **Other comments and references**

We endorse the mandate of communicating key audit matters in the audit of listed entities only, with voluntary disclosure for other entities. We are also supportive of reviewing the extent of mandating key audit matters to other non-listed entities of public significance as part of a post-implementation review process.

We are also very supportive of example KAM's and guidance to be provided by the AUASB outside of the proposed standards to encourage consistent application of the standards across the profession.

We would support the AUASB providing guidance on what an auditor of a listed entity can say in relation to KAM's included in published audit reports at an AGM both when the standard is early adopted and after the implementation of the standard.

Appendix 1 to this letter includes our response to the questions posed in the exposure draft.

Please also refer to Appendix 2, which outlines our comments over the wording used in the example audit reports provided in the proposed standard.

It is important that the AUASB monitors closely user reaction to the revised auditors report. We therefore support the AUASB's planned ongoing and post –implementation reviews.

Please contact Carolyn Ralph or myself if you wish to discuss any of the issues raised in this letter.

Yours sincerely



Martin McGrath

*Partner*

## **Appendix 1 – KPMG responses to the specific questions listed in the AUASB Exposure Drafts**

### ***Explanatory Memorandum questions***

*1 What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of the proposed standards? If significant costs are expected, the AUASB would like to understand:*

- Where those costs are likely to occur;*
- The estimated extent of costs, in percentage terms; and*
- Whether expected costs outweigh the benefits to the users of audit services?*

We anticipate incremental costs to auditors and the business community arising from compliance with the main changes to the requirements of the proposed standards. In particular, costs in the year of transition are expected to be significant.

Additional costs are likely to occur for senior auditors (Partners and Managers) for the following:

- time to train and coach auditors on the changes to requirements;
- time incurred to draft revised firm specific template audit reports including addition of KAMs and other required changes for use by auditors;
- time to implement necessary internal processes and infrastructure to facilitate consistency in the extent of reporting and branding across audit reports issued by the audit firm and to ensure reports are not boiler plate and lacking value;
- first time costs of identification, communication and documentation of KAMs by auditors which is expected to be considerably more in the first year of adoption of the revised standard;
- time incurred by audit teams to draft reports, particularly key audit matters, that are concise and in plain English;
- time incurred to draft or update Audit Committee/Board report incorporating identification and basis of selection of KAMs;
- additional review and consultation time for engagement teams internally;
- increased time for interaction with management and audit committees related to the awareness of the revised auditor reporting standards, communication and review of KAMs and related discussions.

We estimate 30-40 additional hours for each audit.

Additional costs are likely to occur for businesses for the following:

- time to understand changes to requirements;

- time to amend internal processes for financial report preparation and consideration of expanded disclosures;
- time to discuss KAM's internally and with auditors; and
- cost of additional pages in glossy annual report for longer auditor's report and (potential) additional disclosures arising from discussions with auditors regarding KAM disclosures.

We expect to pursue recovery of the additional costs to the audit on the basis of the tangible benefits/insights that arise from these reporting reforms, however, successful recovery of costs will depend on market forces and the ability for Boards / management to understand both the incremental effort required and the value that the changes bring to the users of the financial report.

2 *Whether, in the future, ASA 701 Communicating Key Audit Matters in the Independent Auditor's Report should be mandated in the audit of entities in addition to listed entities; and if so:*

- *Which entities; and*
- *What criteria should be used to identify such entities?*

We endorse the mandate of communicating key audit matters in the audit of listed entities only, with voluntary disclosure for other entities.

In the AUASB post-implementation period, we support the consideration of whether to mandate the communication of key audit matters to audits of other entities, particularly public interest entities, high public profile entities and large not for profits. Agreement on the definition of the entities to be covered would be required given the varying definitions across various legislations/standards currently in existence.

If there is perceived value in mandating key audit matters for other types of entities such as public interest entities, high public profile entities and not for profits and these benefits outweigh the costs of implementation, then the requirement to provide key audit matters could be extended to these other types of entities in the future.

3 *Whether the name of the engagement partner should be disclosed only when required by law or regulations; or for all engagements?*

We agree with the current proposed standard.

- 4 *Whether the removal of (only) “Aus” paragraph references to the Corporations Act 2001—currently included within the requirements and application and other explanatory material—supported?*

We acknowledge the proposal to remove Aus paragraph references to the Corporation Act 2001 would improve alignment to the international standard. However, we do not support the proposal on the basis that the Corporations Act 2001 requirements still apply and include helpful references to unusual circumstances and higher risk scenarios. Inclusion of specific Corporations Act references in the standard provides value as a useful reminder of the requirements, and practical guidance for the practitioner in these unusual situations.

- 5 *If removal of existing references is not supported, respondents are asked to indicate their preference for locating the re-instated material within the standard:*

- *In the requirements and application and other explanatory material (as applicable) of the proposed standard; or*
- *By inclusion of a cross-referenced listing in an appendix to the standard?*

Our preference for locating the re-instated material is as per current status, i.e, within the standard alongside the context specific auditing standard requirement.

***Exposure Draft, Proposed Auditing Standard ASA 700 Forming an Opinion and Reporting on a Financial Report; Exposure Draft, Proposed Auditing Standard ASA 701 Communicating Key Audit Matters in the Independent Auditor's Report; Exposure Draft, Proposed Auditing Standard ASA 705 Modifications to the Opinion in the Independent Auditor's Report, Proposed Auditing Standard ASA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report, Proposed Auditing Standard ASA 570 Going Concern, Proposed Auditing Standard ASA 260 Communication With Those Charged With Governance, Proposed Auditing Standard ASA 2015-1 Amendments to Australian Auditing Standards***

6 *Have applicable laws and regulations been appropriately addressed in the proposed standard?*

Yes, we consider the applicable laws and regulations have been appropriately addressed in the proposed standards. Refer above to commentary in relation to removal of Aus paragraphs to the Corporations Act 2001.

7 *Are there any laws or regulations that may, or do, prevent or impede the application of the proposed standard, or may conflict with the proposed standard?*

No, we are not aware of any laws or regulations that may prevent or impede application of the proposed standard or may conflict with the proposed standard.

8 *Is there support for permitting the auditor to choose whether to locate the auditor's responsibilities section in either the body of the auditor's report or in an accompanying appendix to the auditor's report?*

We strongly support the relocation of the auditor's responsibilities by a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, to allow the greatest flexibility to auditors, including focussing the report on client specific audit matters.

We support permitting the auditor to choose whether to locate the auditor's responsibilities section in either the body of the auditor's report or in an accompanying appendix to the auditor's report. Given the audit report is already the last document in a financial report we believe there is little value to be obtained from relocating the auditor's responsibilities section to an accompanying appendix to the auditor's report.

9 *Are there any other significant public interest matters that constituents wish to raise?*

Refer to commentary on going concern and emphasis of matter interaction with key audit matters in our cover letter.



*10 Is there overall support for the proposed standard?*

Yes, overall, we have supported the changes in the UK and International standards and we continue to support the AUASB initiatives to enhance the transparency of auditor reporting through the proposed standards as outlined in our responses above.

***Proposed Auditing Standard ASA 570 Going Concern***

*11 Do respondents support the retention of the “relevant period” concept set out in paragraph Aus 13.2, which extends the auditor’s going concern assessment period beyond the financial report’s balance date to that of the expected date of the auditor’s report?*

Yes we support the retention of the relevant period concept as this is a well understood concept for local users and practitioners.



## Appendix 2 –Observations and feedback on Illustrations in Proposed Auditing Standard ASA 700

We provide our observations and feedback on the following Illustrations in Proposed Auditing Standard ASA 700:

- **[Aus] Illustration 1A:** *An auditor’s report on a financial report of a single listed company prepared in accordance with the Corporations Act 2001 (a fair presentation framework)*
- **[Aus] Illustration 2A:** *An auditor’s report on a financial report of a listed company (Group) prepared in accordance with the Corporations Act 2001 (a fair presentation framework)*
- **Illustration 3:** *An auditor’s report on a financial report of an entity other than a listed entity prepared in accordance with a fair presentation framework*
- **Illustration 4:** *An auditor’s report on a financial report of an entity other than a listed entity prepared in accordance with a general purpose compliance framework*

Paragraph from template audit report in ASA 700	Reference	Observation/Comments
<b>We have audited the financial report of ABC Company Ltd. (the Company), which comprises the statement of financial position....., and <u>notes to the financial report</u>, including a summary of significant accounting policies, and the directors’ declaration.</b>	[Aus] Illustration 1A	The paragraph incorrectly refers to the notes to the <i>financial report</i> , instead of notes to the <i>financial statements</i> . In Australia, the financial report is a defined term under the Corporations Act 2001, which comprises the financial statements, notes to the financial statements and the directors’ declaration.  We propose correction in [Aus] Illustration 1A to reflect the above and the language in proposed ASA 700.A17.
<b>Directors’ Responsibilities for the Financial Report/ Directors’ Responsibilities</b>	[Aus] Illustration 1A [Aus] Illustration 2A	The format of the heading diverges from proposed ASA 700.32 and the Illustrations in ISA 700 (revised). Based on the International Illustrations, we would expect the heading to be “Responsibilities of the Directors for the Financial Report”.  The heading is also inconsistent between Australian Illustrations 1A and 2A.

Paragraph from template audit report in ASA 700	Reference	Observation/Comments
		We propose alignment with the International standard or where the AUASB deviate from the International standard, application of consistency between Australian Illustrations.
<b>(i) giving a true and fair view of the Company's/Group's Consolidated financial position as at.....and of its (consolidated) financial performance for the <u>year ended on that date</u>; and</b>	[Aus] Illustration 1A [Aus] Illustration 2A	The format of the phrase “year ended on that date” is inconsistent with the Illustrations in ISA 700 (revised). There is also inconsistent application of the phrase within the “Opinion” paragraph in the Australian Illustrations (“year then ended” versus “year ended on that date”).  We propose alignment with the International standard or where the AUASB deviate from the International standard, application of consistency between Australian Illustrations.
<b>Report on the Remuneration Report</b>	[Aus] Illustration 1A [Aus] Illustration 2A	The ordering of content in the “Report on the Remuneration Report” is inconsistent with the ordering of content in the “Report on the Audit of the Financial Report”.  We propose that the opinion is presented first, followed by the respective responsibilities of the directors and auditor.
<b>We are independent of the Company/Group in accordance with the Corporations Act 2001 and the ethical requirements of the Accounting Professional and Ethical Standards Board's APES 110 Code of Ethics for Professional Accountants (the Code) that are relevant to our audit of the financial report in Australia.</b>	[Aus] Illustration 1A [Aus] Illustration 2A	The relevant wording under the “Basis for Opinion” heading deviates from the Illustrations provided in ISA 700 (revised). We are also concerned the full requirements of proposed ASA 700.28(c) are not covered in the proposed wording, specifically the “ <i>and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements</i> ”.  We propose alignment with the International standard or where the AUASB deviate from the International standard, encourage revisiting the wording to

Paragraph from template audit report in ASA 700	Reference	Observation/Comments
		make the sentence more succinct. We seek clarity over how paragraph 28(c) is achieved in the template wording.
<p><b>We have audited the financial report of ABC Company Ltd. (the Company), including its subsidiaries (the Group), which comprises....., notes comprising a summary of significant accounting policies <u>and other explanatory information</u>, and the directors’ declaration of the Company.</b></p>	[Aus] Illustration 2A	<p>The requirement of proposed ASA 700, 24(d) (23(d) in the current ASA 700) no longer requires the opinion section of the auditor’s report to refer to the other explanatory information.</p> <p>We propose updating the Illustration for the requirements of the standard.</p>
<p><b>In our opinion,</b></p> <p><b>The accompanying financial report of ABC Company Ltd., is in accordance with the Corporations Act 2001, including:</b></p> <p>(i) <b>Giving a true and fair view of the Group’s consolidated financial position.....</b></p>	[Aus] Illustration 2A	<p>There are notable inconsistencies between the use of Group and Company in Illustration 2A. In particular, the opinion says “the accompanying financial report of the Company” and then refers to the Group consolidated position in (i).</p> <p>Propose corrections to the Illustration to address inconsistencies.</p>
n/a – Required paragraph has been omitted	[Aus] Illustration 2A	<p>The requirements of Proposed ASA 700 38(c) regarding the auditor’s responsibilities in a group audit engagement are not presented in the Illustration.</p> <p>We propose updating the Illustration for the requirements of the standard.</p>