2020

Statutory Reporting Quality

ISA 701 – Thematic Review

IAASA
Irish Auditing & Accounting Supervisory Authority

Mission

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest.

About IAASA

The Irish Auditing and Accounting Supervisory Authority ('IAASA' or 'the Authority') is designated as the competent authority[1] in Ireland responsible for quality assurance reviews of statutory auditors and audit firms that carry out statutory audits of public-interest entities (audits of PIEs).

The Authority accepts no liability and disclaims all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

[1] Audit reform legislation requires the designation of a competent authority in each member state. Audit reform legislation comprises EU Regulation 537/2014 and Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 [OJ No. L 157, 9.6.2006, p.87] on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, as amended by Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 [OJ No. L 158, 27.5.2014, p.196] amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts. The Directive is transposed into Irish law in the Companies Act 2014.

1. Background

The International Auditing and Assurance Standards Board (IAASB) issued International Standard on Auditing 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. This Standard was subsequently adopted by IAASA (the Authority) as International Standard on Auditing (Ireland) 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (ISA 701). It's effective for the audits of financial statements for periods commencing on or after 17 June 2016, for which opinions are issued on or after 1 February 2017.

ISA 701 deals with the auditor's responsibility to communicate key audit matters (KAMs) in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.

Overview of the changes to Irish auditor's reports

Key Audit Matters (KAMs)

Prior to the adoption of ISA 701, auditor's reports provided information required by ISA 700 *Forming an Opinion and Reporting on Financial Statements*, or required by law. In Ireland, that included confirming whether the auditor believes that proper books of account were kept by the entity and the auditor's overall opinion on whether or not the financial statements presented a true and fair view.

Post adoption of ISA 701, the auditor is required to document KAMs in the auditor's report in respect of 'relevant entities'. 'Relevant entities' are entities listed on any market as well as Public Interest Entities (PIEs) which are those listed on a regulated market, all insurance undertakings and all credit institutions.

Communicating KAMs provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, are of most significance in the audit of the financial statements of the current period. Communicating KAMs may also assist intended users in understanding the entity and the areas of significant management judgment exercised in preparing the financial statements

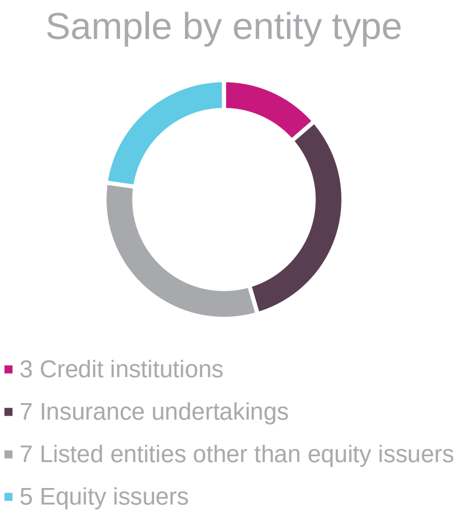
In determining what qualifies as a KAM, the auditor must consider areas of higher risk of material misstatement, significant risk, significant auditor judgments related to significant management judgment (including accounting estimates) and significant events or transactions. An auditor's report must set out:

(a) a description of each of the KAMs;
(b) the auditor's response to the KAMs; and
(c) the auditor's key observations in relation to the KAMs.

2. Purpose and extent of the survey

The Authority surveyed 22 PIE auditor's reports, spread across all PIE types and for all firms that carry out statutory audits of PIEs. The purpose of the survey was to explore how auditors complied with the requirements of ISA 701.

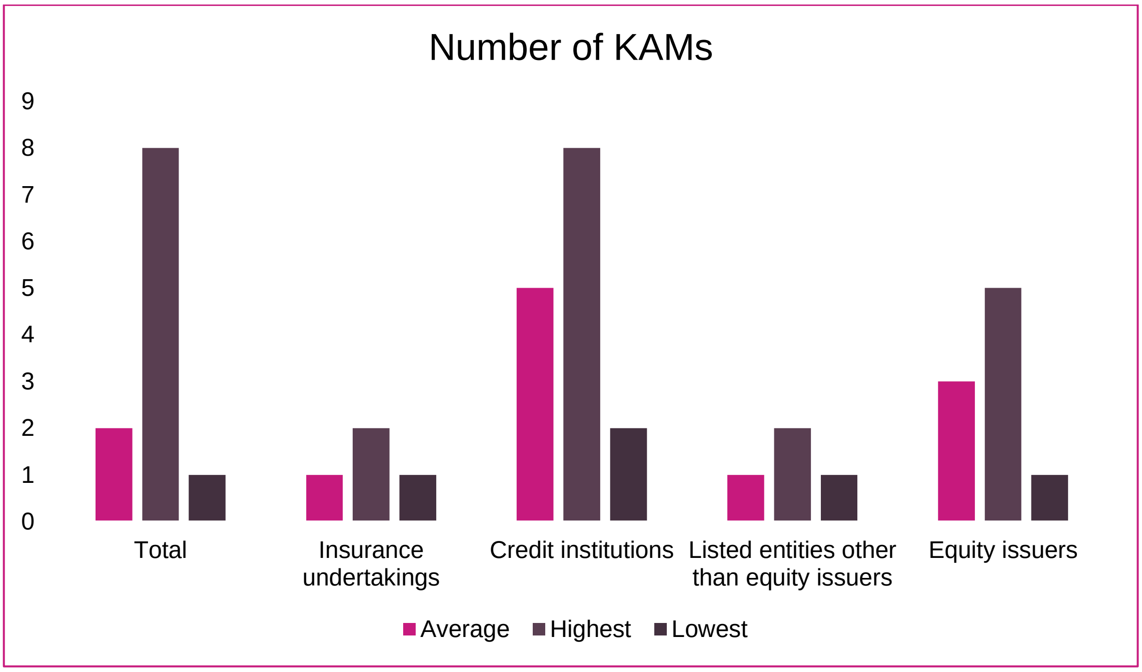
Table 1 – Sample by entity type



The Authority surveyed the 22 auditor's reports under the following headings:

2.1 the reporting of KAMs;
2.2 the reporting of materiality; and
2.3 the reporting of the scope of the audit, including how each KAM was addressed and how the scope was influenced by materiality

2.1 The reporting of KAMs



Below, this paper analyses the reporting of KAMs under three headings: Risks, Granularity, and The Inclusion of Findings.

The section on risks deals with what risks were identified by the auditors as KAMs and how this varied between sectors. In the section on granularity the paper discusses how specific or generic individual KAMs are, and in the Inclusion of Findings section we survey whether findings were included within the text of each KAM or elsewhere in the report.

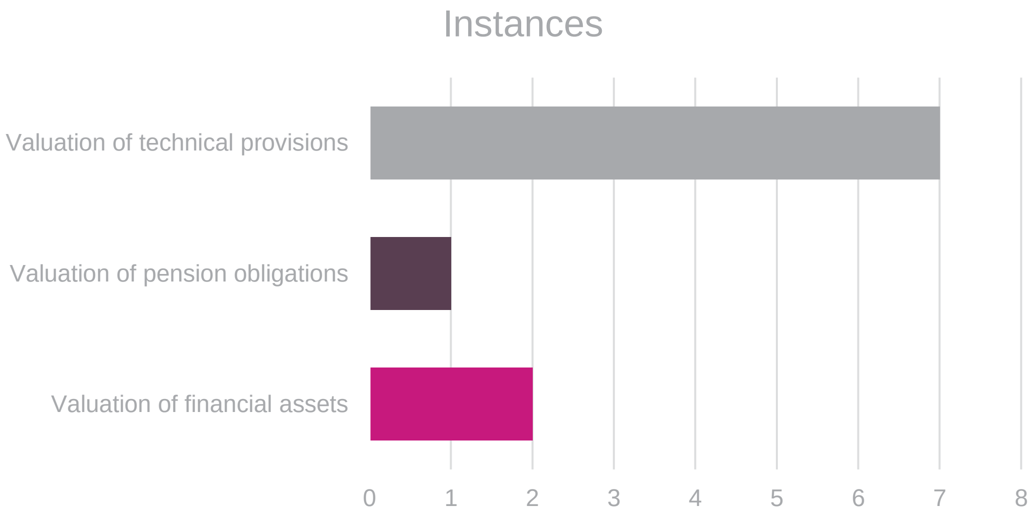
2.1a Risks

International Standard on Auditing (Ireland) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* (ISA 240), identifies management override of controls as a significant risk in all audits. However, there is no requirement to report it as a KAM if, in the auditor's professional judgment, it is not a matter of most significance in the audit of the financial statements. It was not reported as a KAM in any of the auditor's reports examined, in any sector.

Insurance undertakings

The Authority surveyed the auditor's reports of seven insurance undertakings, including life-insurance, non-life insurance and reinsurance undertakings.

The KAMs identified in these reports were as follows:

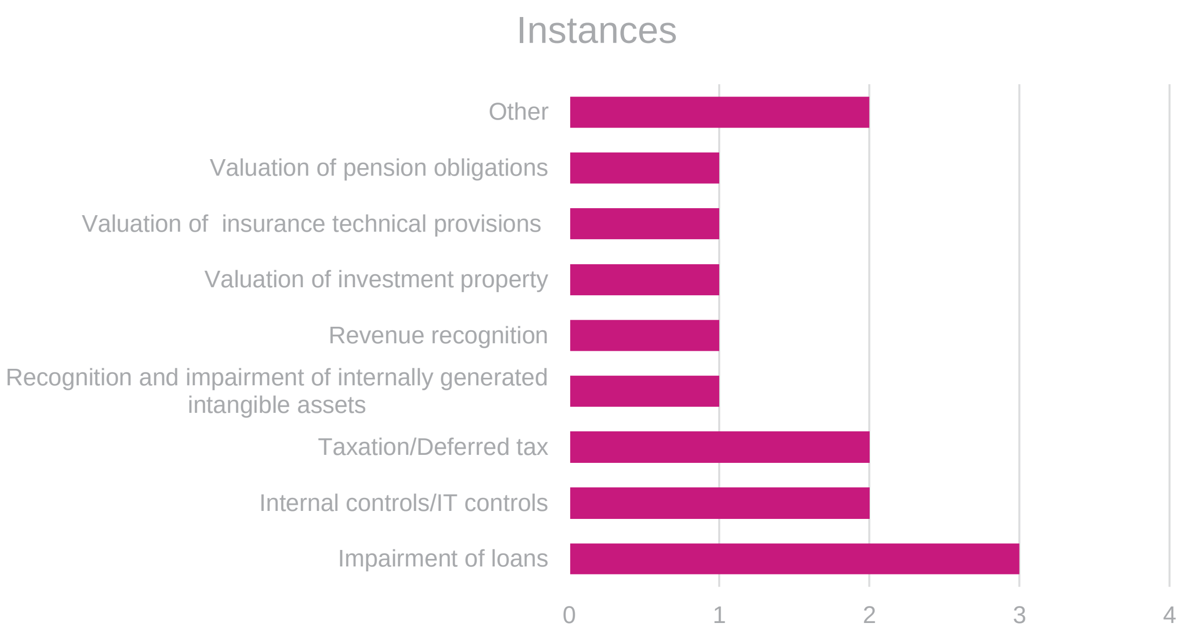


The most common risk auditors identified for insurance undertaking audits is *valuation or adequacy of insurance technical provisions*. This is, in general terms, the risk that the technical reserves are insufficient and/or the risk that they are incorrectly estimated. Auditors included this risk in each of the seven reports surveyed.

ISA 240 allows for the rebuttable presumption that there are risks of fraud in revenue recognition. It is common for such risks to be rebutted in the audit of insurance undertakings. We note that revenue recognition was not identified as a KAM in any of the insurance sector auditor's reports examined and, therefore, note that either the risk was rebutted in these audits or that it was identified as a risk but not as a KAM. Either of these approaches may be valid depending on the particular circumstances of the audit.

Credit institutions

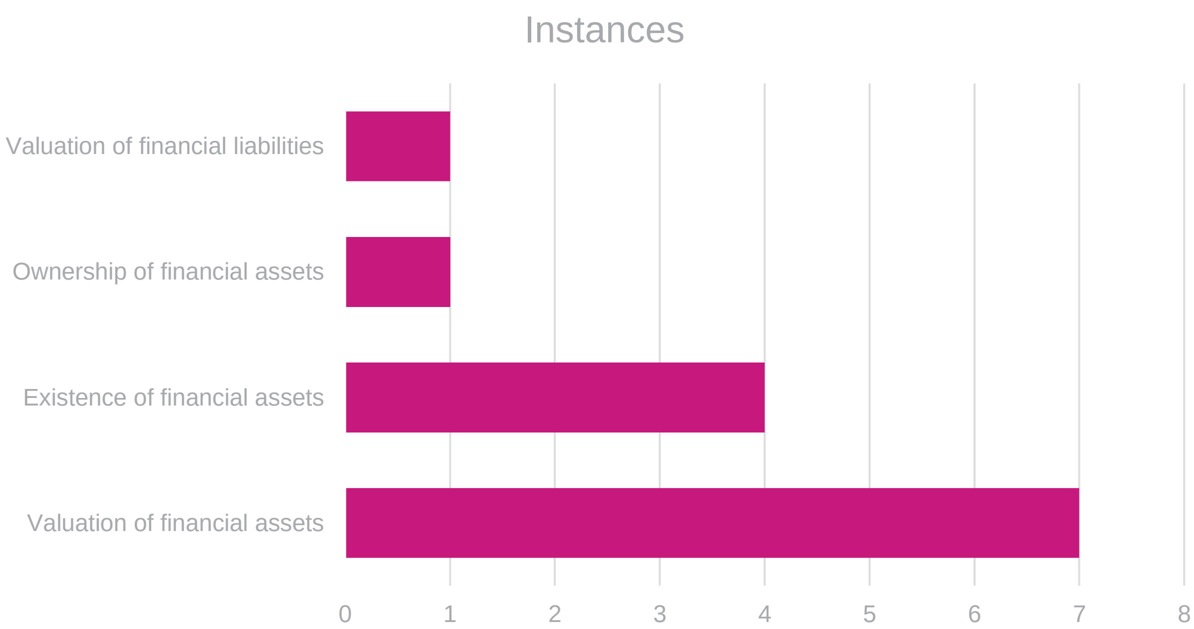
The Authority surveyed the auditor's reports of three banks. The auditors' reports had four, two and eight KAMs respectively. The KAMs were as follows:



Notably, a KAM in respect of impairment of loans appears in each audit report of the three banks, but the details of the risk and audit approach vary.

Listed entities other than equity issuers

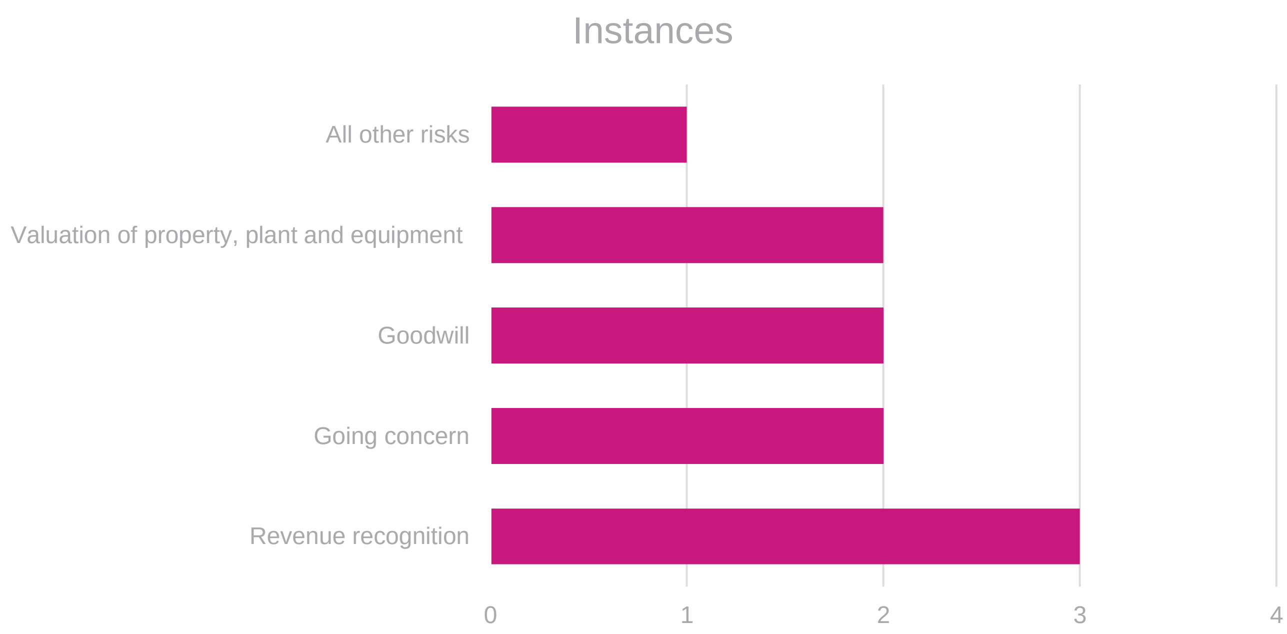
Seven audit reports surveyed in this sector. We noted a significant overlap in the risks identified by the different auditors. They were as follows:



Equity issuers

This group consists of companies with listed equity, but excludes companies in insurance, banking, funds and debt.

The risks identified were as follows:



Given the disparity of the industries involved in this part of the survey, not many inferences can be drawn from the commonality of risks among the auditor's reports.

However, we note that revenue recognition was identified as a KAM in three of the five equity issuers' auditor's reports surveyed. This is in contrast to the other industries included in our review, where it was only once identified as a KAM (in one of the credit institutions).

Given that there is a rebuttable presumption that there are risks of fraud in respect of revenue recognition, this disparity could be a result of either:

(a) an increased tendency of audits of companies in the insurance, banking and asset management sector to rebut the risk of revenue recognition; or

(b) in cases where a fraud risk in relation to revenue recognition has been identified in these industries, a reduced tendency to identify these fraud risks as KAM in those industries.

2.1b Granularity

ISA 701 states that, in order to be useful to users of the financial statements, the explanations of the matters set out in the auditor's report shall be described in a way that enables them to be related directly to the specific circumstances of the entity and are not, therefore, generic or abstract matters expressed in standardised language.

Our interpretation of whether language is specific or generic is subjective. As such, the reader should not conclude based on this survey that audit reports written in generic language are necessarily in breach of the requirements of ISA 701.

	Insurance undertakings		**Credit institutions**		**Listed entities other than equity issuers**		**Equity issuers**	
	Specific	Generic	Specific	Generic	Specific	Generic	Specific	Generic
Description of the risk	6	1	3	-	5	2	5	-
How the matter was addressed	5	2	3	-	6	1	5	-
Key observations	-	7	3	-	-	7	2	3

Insurance undertakings

The auditors in the insurance sector appear to adopt high levels of specificity when describing the risks but revert to generic language when discussing how it was addressed.

An example of specific language used in the description of a risk is as follows:

As stated in notes [x] and [y] the company uses judgments in determining the technical reserves, in selecting actuarial techniques that take into account quantitative loss experience data together with any qualitative factors where appropriate.

The technical provisions balance represents the largest liability for the company. Valuation of it is highly judgmental because it requires a number of assumptions to be made with high estimation uncertainty. The determination and application of the methodology and performance of the calculations are complex. There remain inherent uncertainties in relation to the valuation of the reserves estimate that are increased for reinsurers because of the longer time period between the date of an occurrence and the request for payment of the claim to the reinsurer, the dependence on ceding companies for information regarding claims, the accuracy and completeness of the actuarial data and differing reserving practices among ceding companies.

An example of generic language used in the description of a risk is as follows:

> We consider the valuation of the Company's technical provisions to be a significant risk for the Company as these reserves are based on judgment based on the assumptions used and are reliant on the completeness and accuracy of underlying data.

In respect of key observations, generic language used in the auditor's reports included:

> We completed our planned audit procedures, with no material exceptions noted

and,

> Our opinion on the financial statements is not modified with respect to any of the risks described above.

Credit institutions

For each of the KAMs in each of the three auditor's reports, the risks were granular and specific to the banks being audited. By most measures, these three banks are larger than the insurance undertakings surveyed above and so it follows that the audits are likely to be more complex. This appears to be reflected in the level of detail included in the auditor's report.

Listed entities other than equity issuers

Like insurance undertakings and banks, the auditors of asset management companies have tended towards including details of the risk and how it was addressed that are specific to the companies. In each case the key observations were generic.

Equity issuers

Every risk in each of these auditor's reports was documented in granular detail, as were the procedures to address the risk.

An example of a granular risk described in an equity issuer's audit report is as follows:

> There is a risk that the Group's creditor balance with the [Company B] will not be recovered. As at year-end, the Group is owed €X by [Company B] of which the Company's share amounted to €Y. The Group expects this to be fully recoverable as the [Company B] are not disputing the sales value owed. However, the [Company B] have identified potential liabilities for separate amounts it believes are due to them by the Group and is seeking to offset these amounts against the debtor balance. There has been no resolution to date on this matter.

2.1c The inclusion of findings

	Insurance undertakings		Credit institutions		Listed entities other than equity issuers		Equity issuers	
	Specific	Generic	Specific	Generic	Specific	Generic	Specific	Generic
Conclusion included within KAM	-	4	2	1	-	6	2	3
Conclusion included elsewhere	-	3	-	-	-	1	-	-

14 of the 22 auditor's reports surveyed included generic conclusions within the KAM section of the auditor's report.

Examples of these include:

> There were no specific matters arising from our testing….

> Our planned audit procedures were completed without material exception…

> No matters were noted as a result of performing these procedures…

In the auditor's reports of two of the equity issuers surveyed, and two of the credit institutions, the auditor included specific observations in respect of each individual KAM. These observations were more detailed in the equity issuers. Examples include:

> Management engaged significant external resources to assist the Company's valuation of [X]. However, as a result of a breakdown in internal controls we were unable to obtain sufficient appropriate audit evidence to form a conclusion on this account nor were we able to perform alternative procedures and thus were unable to determine whether any adjustments were necessary.

Interestingly, in the case of two other reports (equity issuers – generic observations), the auditor described the contents of the observation without actually communicating what the observation was. For example, the auditor included the following wording in one:

> Our observations included an outline of the range of audit procedures performed, the key judgements involved, the principal considerations arising from IFRS 15 adoption and the results of our testing.

2.2 The reporting of materiality

In the auditor's report, the auditor is required to include an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole. In addition to this, the auditor may communicate:

i. materiality level or levels for those classes of transactions, account balances or disclosures where such materiality levels are lower than materiality for the financial statements as a whole (as described in paragraph 10 of International Standard on Auditing (Ireland) 320 *Materiality in Planning and Performing an Audit (ISA 320)*);

ii. performance materiality (as described in paragraph 11 of ISA 320);

iii. any significant revisions of materiality thresholds that were made as the audit progressed;

iv. the threshold used for reporting unadjusted differences to the audit committee; and

v. significant qualitative considerations relating to the auditor's evaluation of materiality.

In the table below, we set out how our sample of 22 auditor's reports dealt with each of these requirements and suggestions. We did not note any sectoral trends.

	Specific	**Generic**	**Not included**
a) An explanation of how the auditor applied the concept of materiality in planning and performing the audit (mandatory)	-	22	-
b) Threshold used by the auditor as being materiality for the financial statements as a whole (mandatory)	22	-	-
c) Materiality level or levels for those classes of transactions, account balances or disclosures where such materiality levels are lower than materiality for the financial statements as a whole (or performance materiality) (optional)	6	16	-
d) Any significant revisions of materiality thresholds that were made as the audit progressed (optional)	-	-	-
e) The threshold used for reporting unadjusted differences to the audit committee (optional)	22	-	-
f) Significant qualitative considerations relating to the auditor's evaluation of materiality (optional)	3	13	6

a) All auditor's reports surveyed used generic language to meet this requirement. Examples of language included:

We used materiality in both planning the scope of our audit work and evaluating the results of our work

and

Materiality provides a basis for determining the nature and extent of our audit procedures the results of our work.

and

Our audit of the Company was undertaken to the materiality level specified above.

b) The threshold used by the auditor for determining materiality is a mandatory disclosure and was included in every auditor's report surveyed. The thresholds used varied by industry.

c) Though the majority of the reports do not include materiality levels for individual classes of transactions, a minority include the performance materiality thresholds. This is an optional disclosure.

d) This was not disclosed in any of the auditor's reports surveyed. It is possible that there were no significant revisions of materiality thresholds.

e) Notably, although the disclosure is optional, every auditor's report surveyed included a disclosure of the threshold used for reporting unadjusted differences to the Audit Committee.

In respect of the optional requirement to disclose significant qualitative considerations relating to the auditor's evaluation of materiality, most auditors chose to include generic disclosures such as "we have considered qualitative factors", but without any explanation as to what these factors were. Six of the 22 surveyed did not make any disclosure in respect of qualitative factors, and three made detailed, specific disclosures that included details of what the factors are and how they affected the calculation.

Exampled of detailed disclosures include:

We determined materiality to be €X. This has been determined by considering a number of different measures including total assets and profit. The low interest rate environment has decreased profit significantly for the year and, as such, we have considered a range of metrics.

We also consider the expected pre-tax profit and shareholder's equity to be critical components for determining materiality because the key driver of performance is expected to be pre-tax profit. The economic decisions of a reasonably knowledgeable person would be influenced by a change in profitability and shareholder's equity is placed under scrutiny by local regulators, and is therefore a key financial metric regularly assessed by the stakeholder. We have considered quantitative and qualitative factors such as understanding the entity and it's environment, history of misstatements

and:

We have considered quantitative and qualitative factors such as our understanding of the entity and its environment, the history of misstatements, the complexity of the company and the reliability of the control environment.

In determining materiality we considered financial metrics which we believe to be most relevant to the users of the financial statements, including Shareholder's Funds which we have determined to be the most relevant benchmark as it t is placed under scrutiny by local regulators and is a key metric regularly assessed by management and shareholders.

In contrast, examples of generic disclosures include:

We have considered qualitative and quantitative factors in determining *materiality*

and:

We have set performance materiality at this level having given consideration to our prior year experience of the risk of misstatements.

2.3 The reporting of the scope of the audit

ISA 701 requires the auditor's report to provide an overview of the scope of the audit including an explanation of how such scope:

i) addressed each KAM ; and
ii) was influenced by the auditor's application of materiality

The auditor's report may also include details such as the coverage attained on certain account balances or the nature of involvement of the group auditor in the work of component auditors.

	Specific	Generic	Not included
How scope was influenced by each KAM (mandatory)	22	-	-
How scope was influenced by application of materiality (mandatory)	8	14	-
Coverage of certain accounts (optional)	6	-	16
Nature of involvement in work of component auditor (optional)	5	-	17

Each of the auditor's reports surveyed detailed how the scope was influenced by the KAM in a manner specific to the entity being audited.

Auditors varied in how they documented how the scope was influenced by the application of materiality. Some of the more detailed reports discuss how materiality influenced their selection of components to audit, the nature of involvement in the work of the component auditor and/or the coverage attained over certain account balances.

3. Concluding summary

It is apparent that auditors are, in general, complying with the requirements of the ISA. Audit firms tend to include specific language when discussing the risk within the KAM, but tend to include generic information more often when discussing observations, materiality, or the scope of the audit. However, this distinction between specific and generic is subjective.

Some characteristics of the most informative auditor's reports are:

i) detailed, specific descriptions of the nature of the risks, how the matter was addressed and key observations;

ii) the inclusion of key observations in the body of the KAM;

iii) specific reporting on how materiality was applied, including thresholds such as performance materiality and the threshold for reporting unadjusted differences. Also, details of qualitative considerations relating to the evaluation of materiality; and

iv) specific, granular details of how the scope was influenced by each KAM and how it was influenced by materiality. This may include coverage obtained over certain accounts and, in the cases of group audits, the nature of involvement in the work of the component auditor.

The adoption of ISA 701 allows the auditor to tailor the report for each individual entity and to reflect their view on those matters that required significant auditor attention. We recommend that audit firms move towards increased levels of specificity in the auditor's report, and that they consider the characteristics of the most informative auditor's reports described above.

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