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Audit report to disclose key judgements and other significant matters

The International Auditing and Assurance Standards Board (IAASB) recently released an exposure draft entitled *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*, which proposes significant changes to audit reports.

The IAASB has issued these proposals in response to constituent feedback following the global financial crisis and European Commission (EC) proposals on audit reform, both calling for increased transparency about the audit that has been performed.

The most significant change is to require auditors to disclose key audit matters in the audit report, being “those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period”. The auditor will consider those areas of the financial statements that are significant risks, involve significant auditor judgement, areas where difficulty was encountered during the audit (such as difficulty obtaining sufficient appropriate audit evidence) and circumstances where the auditor had to significantly modify the audit approach, including as a result of the identification of a significant deficiency in internal control.

The IAASB notes that the communication of key audit matters may change the processes entities use to prepare and present financial statements, including related disclosures. Therefore, the IAASB is particularly interested in views from stakeholders about the implications of this change, including additional effort or costs that may be expected for preparers.

Changes proposed

Key audit matters

The most significant change proposed in the exposure draft is to require the audit report for audits of listed entity financial statements to include a new section outlining the key audit matters arising during the audit, being *“those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period”*. Such matters would be selected from the matters communicated by the auditor to those charged with governance over the entity being audited (for a New Zealand company this is typically the Board of Directors).

Auditors will need to identify which of the matters communicated with those charged with governance should be included in the audit report. The proposals specify that the auditor should consider:

- Areas identified as significant risks,
- Areas involving significant auditor judgement,
- Areas where the auditor encountered significant difficulty during the audit, including with respect to obtaining sufficient appropriate audit evidence, and
- Circumstances that required significant modification in the auditor’s planned approach, including as a result of the identification of a significant deficiency in internal control.

We have included an illustrative audit report on pages 5 to 8 which includes four examples of key audit matters that may be disclosed. These examples were provided by the IAASB to illustrate the proposals, however this section of the audit report would be tailored to the specific facts and circumstances of an individual audit engagement so could vary significantly to the examples provided (both in number of items disclosed and how they are described).

The IAASB notes that the communication of key audit matters represents *“a particularly significant change”* and may change the processes entities use to prepare and present financial statements, including related disclosures. Therefore, the IAASB is particularly interested in views from stakeholders about the implications of this change, including additional effort or costs that may be expected.

Independence

An explicit statement that the auditor is independent of the entity and has fulfilled any other relevant ethical requirements, would be disclosed in the audit report, including the sources of the ethical requirements.

Engagement partner

For audits of financial statements of listed entities, the audit report would be required to explicitly state the name of the engagement partner.

Prominence of opinion

The auditor’s opinion would be placed at the beginning of the audit report.

Ordering

Whilst not mandating specific requirements, the proposals outline a preferred ordering and placement of the elements of the audit report.

Going concern

The auditor would be required to report on going concern in the audit report. This would include a conclusion on the appropriateness of the directors’ use of the going concern basis and a statement whether a material uncertainty about going concern has been identified.

Auditor responsibilities

Improvements are proposed about how the responsibilities of the auditor are described and the key features of the audit. Some elements of the description of responsibilities would be permitted to be moved to an appendix, or referenced from a website of an appropriate authority. We expect that the External Reporting Board (XRB) will provide a website page for reference.

New Zealand considerations

The IAASB's proposed audit report changes were included for discussion in the New Zealand Auditing and Assurance Standards Board's (NZAuASB) agenda for their meeting on 21 August 2013. We expect that submissions will be sought on whether the changes proposed for listed entities should be extended to include all issuers. The agenda papers also noted that other changes to audit reports may be proposed as a result of the new accounting standards framework and future legislative changes proposed.

Reasons for the proposed changes

As a result of the global financial crisis, there have been calls for the auditor's report to be more informative. The IAASB has undertaken several rounds of consultation (with consultation documents issued in both 2011 and 2012), and the exposure draft represents the results of those consultations.

The IAASB notes that *"Because the auditor's report is the key deliverable addressing the output of the audit process, changes in auditor reporting may have positive benefits on audit quality or users' perception of it. This in turn may increase the confidence that users have in the audit and the financial statements, which is in the public interest."*

They note that these changes will:

- Enhance the communicative value of the auditor's report
- Increase attention by those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report
- Renew focus of the auditor on matters to be reported, which could indirectly result in an increase in professional scepticism, and
- Enhance communications between the auditor and those charged with governance.



The proposed 'key audit matters' section of the audit report replaces earlier proposals for an 'auditor commentary' which would have required the audit report to highlight matters *"likely to be most important to users' understanding of the audited financial statements or the audit"*. Feedback from the earlier proposals expressed concern about the emphasis on users (in that it would require the auditor to take responsibility for determining what is important to a user's understanding of the financial statements), and that it might lead to the inclusion of 'original information' in the audit report (which may blur the roles of those charged with governance and the auditor). The revised proposals for the 'key audit matters' section responds to these concerns by linking it with the dialogue with those charged with governance and focusing it on the audit process.

Illustrative Audit Report

We have tailored the IAASB's example audit report to provide an illustration of what the audit report might look like for a New Zealand listed company based on current legislation (Financial Reporting Act 1993 and Companies Act 1993) where a "clean" (i.e. unmodified) opinion is issued, and incorporated initial indications from the NZAuASB meeting agenda papers. This is included on pages 5 to 8.

Possible Effective Date

The exposure draft suggests that a possible effective date for these proposals may be for audits of financial statements for periods **beginning** on or after 15 December 2015 (so for a December balance date entity it would be first applicable for the 31 December 2016 audit report). However the IAASB is interested in views on whether an earlier date would be feasible, should the standard be issued in the fourth quarter of 2014 – such as periods **ending** on or after 15 December 2015 (so would be applicable to a December balance date at 31 December 2015).

Submissions

Submissions are expected to be due to the NZAuASB around a month prior to the IAASB deadline below. We anticipate that the exposure draft, plus requests for comment on any matters relevant in a New Zealand context, will shortly be added to the XRB website here: http://www.xrb.govt.nz/Site/Auditing_Assurance_Standards/Exposure_Drafts/Current_Exposure_Drafts.aspx

Submissions are due to the IAASB by 22 November 2013. The exposure draft is available on the IFAC website at: <https://www.ifac.org/publications-resources/reporting-audited-financial-statements-proposed-new-and-revised-international>



Illustrative Audit Report for a New Zealand Listed Company

INDEPENDENT AUDITOR'S REPORT To the Shareholders of ABC Limited

Report on the Audit of the Consolidated Financial Statements

Opinion

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, (or give a true and fair view of) the consolidated financial position of ABC Limited and its subsidiaries (the Group) as at 31 December 20X1 and (of) their consolidated financial performance and their consolidated cash flows for the year then ended in accordance with New Zealand Equivalents to International Financial Reporting Standards (NZ IFRSs).

The NZAuASB is considering changes to the references in the audit report as a result of the multi-tiered framework and future changes to legislation. This includes considering whether there should be references to GAAP and the suite of standards adopted by an entity. The NZAuASB was scheduled to discuss this at their meeting on 21 August 2013 so we expect a request for comment to be issued shortly.

We have audited the consolidated financial statements of the Group, which comprise the consolidated statement of financial position as at 31 December 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (New Zealand) (ISAs (NZ)). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group within the meaning of Professional and Ethical Standard 1 and have fulfilled our other responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other than in our capacity as auditor we have no relationship with, or interests in ABC Limited.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements. Key audit matters are selected from the matters communicated with the Board of Directors, but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the consolidated financial statements as a whole. Our opinion on the consolidated financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.

The four specific topics and content presented below are purely for illustrative purposes. This section would be tailored to the facts and circumstances of the individual audit engagement and the entity. Accordingly, the IAASB has intentionally drafted these examples in a manner that illustrates that Key Audit Matters will vary in terms of the number and selection of topics addressed and the nature in which they may be described, and are intended to be consistent with the disclosures in the entity's consolidated financial statements.

Goodwill

Under NZ IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the assessment process is complex and highly judgmental and is based on assumptions that are affected by expected future market or economic conditions, particularly those in [Countries X and Y]. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business lines]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill. The Group's disclosures about goodwill are included in Note X, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Valuation of Financial Instruments

The Group's disclosures about its structured financial instruments are included in Note X. The Group's investments in structured financial instruments represent [x%] of the total amount of its financial instruments. Because the valuation of the Group's structured financial instruments is not based on quoted prices in active markets, there is significant measurement uncertainty involved in this valuation. As a result, the valuation of these instruments was significant to our audit. The Group has determined it is necessary to use an entity-developed model to value these instruments, due to their unique structure and terms. We challenged the rationale for using an entity-developed model and discussed this with the Board of Directors, and we concluded the use of such a model was appropriate. Our audit procedures also included, among others, testing the controls related to the development and calibration of the model and confirming that the directors had determined it was not necessary to make any adjustments to the output of the model to reflect the assumptions that marketplace participants would use in similar circumstances.

Acquisition of XYZ Business

As described in Note X, in December 20X1, the Group completed the acquisition of XYZ Business. XYZ Business was a division of a large private company. As of 31 December 20X1, the Group has completed the initial acquisition accounting on a preliminary basis. The Group will finalise the initial acquisition accounting during 20X2, and the amounts recorded as of 31 December 20X1 could change. We focused on this transaction because it is material to the consolidated financial statements as a whole and the fact that values had not previously been assigned to the division as a standalone operation. In addition, determining the assumptions that underlie the initial acquisition accounting and the useful lives associated with the acquired intangible assets involves significant judgment given the nature of the [name of industry].

Revenue Recognition Relating to Long-Term Contracts

The terms and conditions of the Group's long-term contracts in its [name of segment] affect the revenue that the Group recognises in a period, and the revenue from such contracts represents a material amount of the Group's total revenue. The process to measure the amount of revenue to recognise in the [name of industry], including the determination of the appropriate timing of recognition, involves significant judgment. We identified revenue recognition of long-term contracts as a significant risk requiring special audit consideration. This is because side agreements may exist that effectively amend the original contracts, and such side agreements may be inadvertently unrecorded or deliberately concealed and therefore present a risk of material misstatement due to fraud. In addition to testing the controls the Group has put in place over its process to enter into and record long-term contracts and other audit procedures, we considered it necessary to confirm the terms of these contracts directly with customers and testing journal entries related to revenue recognition. Based on the audit procedures performed, we did not find evidence of the existence of side agreements. The Group's disclosures about revenue recognition are included in the summary of significant accounting policies in Note X, as well as Note X.

Going Concern

The consolidated financial statements of the Group have been prepared using the going concern basis of accounting. The use of this basis of accounting is appropriate unless the directors either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so. As part of our audit of the consolidated financial statements, we have concluded that the use of the going concern basis of accounting by the directors in the preparation of the Group's consolidated financial statements is appropriate.

The directors have not identified a material uncertainty that may cast significant doubt on the Group's ability to continue as a going concern, and accordingly none is disclosed in the consolidated financial statements of the Group. Based on our audit of the consolidated financial statements of the Group, we also have not identified such a material uncertainty. However, neither the directors nor the auditor can guarantee the Group's ability to continue as a going concern.

Other Information

The illustrative wording for this section is subject to the finalisation of proposed ISA (NZ) 720 (Revised). The content of this section may include, among other matters; (a) a description of the auditor's responsibilities with respect to other Information; (b) identification of the document(s) available at the date of the auditor's report that contain the other information to which the auditor's responsibilities apply; (c) a statement addressing the outcome of the auditor's work on the other information; and (d) a statement that the auditor has not audited or reviewed the other information and, accordingly does not express an audit opinion or a review conclusion on it.

Responsibilities of the Directors for the Consolidated Financial Statements

The directors are responsible for the preparation and fair presentation of these consolidated financial statements in accordance with NZ IFRSs¹ and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error. The directors are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

The objectives of our audit are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (NZ) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

The remaining material in this section can be located in an Appendix to the auditor's report (see paragraph 39 of proposed ISA 700 (Revised)). When law, regulation or national auditing standards expressly permits, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report (see paragraph 40 of proposed ISA 700 (Revised)).

¹ Where the directors' responsibility is to prepare financial statements that give a true and fair view, this may read: "The directors are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with NZ IFRSs, and for such..."

As part of an audit in accordance with ISAs (NZ), we exercise professional judgment and maintain professional scepticism throughout the planning and performance of the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities and business activities within the group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We are required to communicate with the directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We are also required to provide the directors with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

Report on Other Legal and Regulatory Requirements

This section of the audit report is expected to no longer be required if changes to the Financial Reporting Act 1993 are passed as proposed. The text below is based on current requirements.

We also report in accordance with section 16 of the Financial Reporting Act 1993. In relation to our audit of the financial statements for the year ended 31 December 20X1:

- We have obtained all the information and explanations we have required; and
- In our opinion proper accounting records have been kept by ABC Limited as far as appears from our examination of those records.

The engagement partner responsible for the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm]

[Auditor Address]

[Date]

Contacts

Auckland

Denise Hodgkins

+64 (0) 9 303 0918
dhodgkins@deloitte.co.nz

Peter Gulliver

+64 (0) 9 303 0891
pegulliver@deloitte.co.nz

Wellington

Trevor Deed

+64 (0) 4 470 3527
tdeed@deloitte.co.nz

Jacqueline Robertson

+64 (0) 4 470 3561
jacrobertson@deloitte.co.nz

Christchurch

Paul Bryden

+64 (0) 3 363 3862
pbryden@deloitte.co.nz

Michael Wilkes

+64 (0) 3 363 3845
mwilkes@deloitte.co.nz

Dunedin

Mike Hawken

+64 (0) 3 474 8684
mhawken@deloitte.co.nz

Brett Tomkins

+64 (0) 3 471 4341
btomkins@deloitte.co.nz

Hamilton

Bruno Dente

+64 (0) 7 834 7842
bdente@deloitte.co.nz

New Zealand Directory

Auckland PO Box 33, Ph +64 (0) 9 309 4944, Fax +64 (0) 9 309 4947

Hamilton PO Box 17, Ph +64 (0) 7 838 4800, Fax +64 (0) 7 838 4810

Rotorua PO Box 12003, Ph +64 (0) 4 472 1677, Fax +64 (0) 4 472 8023

Wellington PO Box 1990, Ph +64 (0) 4 472 1677, Fax +64 (0) 4 472 8023

Christchurch PO Box 248, Ph +64 (0) 3 379 7010, Fax +64 (0) 3 366 6539

Dunedin PO Box 1245, Ph +64 (0) 3 474 8630, Fax +64 (0) 3 474 8650

Internet address <http://www.deloitte.co.nz>

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The Editor,
Accounting Alert
PO Box 33, Auckland.
Ph +64 (0) 9 309 4944
Fax +64 (0) 9 309 4947