



Key audit matters

A stock take of the first year in New Zealand

November 2017



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Introduction to XRB



The External Reporting Board (XRB) is the independent Crown Entity responsible for accounting and assurance standards in New Zealand. The New Zealand Auditing and Assurance Standards Board (NZAuASB) has delegated authority from the XRB Board to develop or adopt, and issue auditing and assurance standards. All XRB standards are designed to give New Zealanders trust and confidence in the financial reporting of our organisations, across the for profit, not-for profit and public sectors.

Introduction to FMA



The Financial Markets Authority (FMA) plays a critical role in regulating capital markets and financial services in New Zealand. They are the New Zealand government agency responsible for enforcing securities, financial reporting and company law as they apply to financial services and securities markets. FMA also regulate securities exchanges, financial advisers and brokers, auditors, trustees and issuers – including issuers of KiwiSaver and superannuation schemes. Jointly, they oversee designated settlement systems in New Zealand, with the Reserve Bank of New Zealand (RBNZ). The FMA’s vision is to promote and facilitate the development of fair, efficient and transparent financial markets.

About this publication

Auditors in New Zealand and around the world have been required to amend their auditor's reports effective for audits of financial statements for periods ending on or after 15 December 2016. These represent the most visible change to the auditor's report in more than 50 years. 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 a stock take of the New Zealand experience in the first year of adopting the revised auditor's report, specifically focussing on the reporting of key audit matters (KAMs). We briefly consider the impact of the other amendments on page 24-25.

To prepare this publication we analysed the new style auditors' reports issued in New Zealand. We also conducted interviews and online surveys with investors, analysts, auditors, directors and management. We thank those who have generously shared their views and experiences with us.

We hope this publication provides further insights and learnings to help improve New Zealand auditor reporting.

A focus on key audit matters (KAMs)

The biggest change to the auditor's report is the communication of KAMs. The requirement to report KAMs, at this stage, is for a subset of audits only. It is mandatory for all auditors of listed issuers from December 2016 and for all FMC reporting entities considered to have a higher level of public accountability¹ from December 2018.

The auditor's report is no longer limited to a binary "pass/fail" opinion. The driver for these changes was a demand from users for the auditor to provide more insights about the audit process.

KAMs provide an opportunity to share the matters that, in the auditor's judgement, were of most significance in the audit of the current period financial statements. KAMs are selected from matters communicated with those charged with governance.

The auditor is required to identify the KAMs, explain why they are a KAM and to say something about how the KAM was addressed. The specifics of the description are left to the judgement of the auditor. The auditing standards do not require a lengthy description of the auditor's procedures, nor do they require an indication of the outcome of the procedures. The new report is intended to be less boilerplate and provide more specific, useful and relevant information about the audit of an entity.

Understanding key audit matters

What KAMs do:

- ✔ Provide greater transparency about the audit that was performed.
- ✔ Highlight the matters that required the most audit attention.
- ✔ May provide users with a basis to further engage with management and those charged with governance.

KAMs are NOT:

- ✘ A replacement of, or supplement to, the preparer's perspective reported in the financial statements.
- ✘ Intended to "fill the gaps" for disclosures viewed as incomplete.
- ✘ Necessarily a business risk nor an "issue" that the entity needs to resolve.
- ✘ A substitute for the auditor to express a modified opinion.
- ✘ A separate opinion on an individual KAM.

¹ A FMC reporting entity or a class of FMC reporting entity that is considered to have a higher level of public accountability than other FMC reporting entities:

- Under section 461K of the Financial Markets Conduct Act 2013; or
- By notice issued by the FMA under section 461L(1)(l) of the Financial Markets Conduct Act 2013.



Executive summary

Promoting transparency

We heard only positive feedback from the directors we interviewed. They considered that the new auditor's report is promoting transparency, and making the discussions that have always been held between the auditor and the audit committee more transparent to the user. The key benefits identified by the directors interviewed include:

- "Early and healthy discussion on key matters".
- "More engagement with the audit committee on the most significant matters".

More engagement

The preparers we interviewed were pleased with the way their auditors engaged in the process. By engaging early, the new reporting requirements have not created delays nor impacted on already tight reporting deadlines.

The reporting of KAMs did not turn out to be "the end of the world" that some preparers were expecting.

Promotes the relevance of the audit

We have heard that auditors have embraced the opportunity to promote the value and relevance of the audit and have invested a large amount of resource and effort in the process. There is variation in the way in which the new requirements have been implemented. This is expected as the new requirements become ingrained. We are encouraged to see innovation and note that some auditors have exceeded what is required by the auditing standards.

Tips from the first year for auditors:

Begin with the end in mind. Be clear about what you are trying to achieve at the outset.

Plan the time. Factor the multiple internal and external discussions into the audit plan and timetable.

Engage early. Preparers and directors agree that a "no surprises" approach is appreciated. The importance and success of the "dry run" process has been key to the successful implementation of the new auditor's report. This helps to overcome anxiety about what the KAMs would cover.

...but don't pre-empt the KAM. The final KAMs can only be determined after the audit work has been completed. It is good to engage early, but avoid locking in the KAMs too early.

Identify and describe the KAMs clearly. It is important to describe each KAM clearly, why it was considered a key area of audit focus, and be precise on how the audit addressed it.

Use appropriate language. Consider your readers, their background and level of expertise.

Keep innovating. Constant improvement is required to communicate the relevance and value of the audit.

The expectation gap remains

Users are starting to engage with the enhanced reports but it is early days. Only time will tell whether the changes achieve the intended objectives. More information about KAMs is needed to provide greater understanding to users and dispel some of the misconceptions. There is an ongoing need to enhance awareness of the value of the audit among the stakeholders it seeks to serve.



Warren Allen

Chief Executive



The revisions to the auditor's report have been described, by some commentators, as "revolutionary" – the most significant change in a decade.

At the XRB, our focus is on developing standards which engender confidence in the financial reporting of New Zealand's organisations. We believe the new auditor's report is helping to do just that.

We issued the revised auditor reporting standards in New Zealand in 2015, to align with the international standards. Since their launch, we have been actively monitoring the uptake of the revised standards. Given the significance of the changes it is appropriate at this stage to draw breath and reflect on the first year of implementation.

The reporting of KAMs has proven to be successful in jurisdictions which were early adopters. Experience from the UK indicated that it did take two to three years for the implementation of the changes to become firmly embedded. New Zealand is likely to have a similar experience and we expect the reports will continue to evolve over the next few years.

We have seen some early adoption of the new form report by entities known for their leadership in financial reporting.

We are pleased that New Zealand is continuing to take a leading role in public sector auditing. The Office of the Auditor-General issued what we believe is the world's first auditor's report on the financial statements of the Government to include a section on KAMs on 30 September 2016.

These are very positive steps, and we look forward to seeing more innovative approaches amongst both our private and public-sector constituents.



Rob Everett

Chief Executive



At the FMA we focus on promoting confident and informed participation in our financial markets. One of our strategic priorities is investor decision-making.

We welcome the new auditors' reports as they provide useful information for investors about the audit process. This is the first year that the enhanced auditor reporting is mandatory for all listed companies. The improved information should provide increased investor confidence in the reliability of annual financial statements. Our review of these reports indicates that audit firms have made significant efforts to provide high quality information.

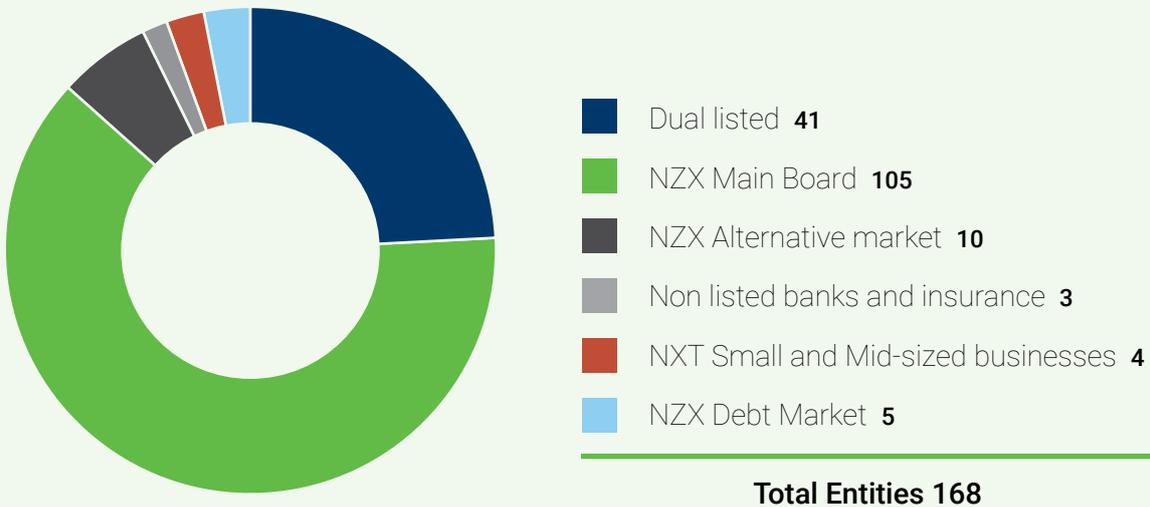
It is good to see that a number of audit firms go beyond the minimum level of compliance requirements and provide additional information to investors such as explaining the materiality threshold used and describing the outcome of the audit procedures performed. This provides an additional level of insight and further clarification of the auditor's role and work. We encourage firms to continue to provide this additional level of disclosure.

We will continue to work with audit firms on further improving the quality of the auditors' reports. Our quality reviews of registered audit firms play an important role as they provide us with the opportunity to review the underlying work supporting the audit opinions issued.

Scope of our “stock take”



Number of entities in each market



Our analysis includes a total of 179 auditors' reports of 168 entities:

- 11 of these entities were early adopters, now in the second year of the revised auditor reporting
- Three of these entities are registered banks and insurance entities which have early adopted the requirements. As non-listed issuers, KAMs are only mandatory from December 2018.

23 entities included in the above sample are small investment funds. These funds have in common the same financial year end, date of opinion, audit firm², fund manager and KAMs. For the purpose of this publication we have considered the investment funds as a single entity.

² A registered audit firm as defined by the Auditor Regulation Act 2011.

Analysis by audit firm



The new auditors' reports are specific to the organisation 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.

Some reports include information about materiality, the scope of the audit and the outcome of audit procedures about the KAMs identified, which are not required by the auditing standards.

Some stakeholders we interviewed expressed a preference for more consistency in areas that are voluntarily reported.

Length of the auditor's report	Deloitte	EY	KPMG	PwC	Other firms ³	Total/Average
Number of opinions	20	22	29	50	25	146
Average page numbers – old	1	1	2	2	2	2
Average page numbers – new	3	4	4	5	4	4

Number of KAMs reported	Deloitte	EY	KPMG	PwC	Other firms
Average number of KAMs	2	3	2	2	2
Highest number of KAMs	4	5	3	4	5
Lowest number of KAMs	1	1	0	0	1

Voluntary reporting	Deloitte	EY	KPMG	PwC	Other firms	Total
Materiality	17	0	24	48	0	89
Outcome of audit procedures	3	0	17	39	3	62
Scope of audit	0	0	6	47	0	53

³ Other firms surveyed with the number of reports indicated include: BDO (5), Staples Rodway Auckland (5), Grant Thornton (4), Staples Rodway (3), Crowe Horwath (2).

Non-standard reports	Deloitte	EY	KPMG	PwC	Other firms	Total
Material uncertainty relating to going concern	2	1	3	5	6	17
Emphasis of matter [#]	0	0	0	1	1	2
Other matter [#]	0	0	0	0	1	1
Qualification	0	0	0	1	0	1
Disclaimer on going concern [*]	0	0	0	2	1	3
Disclaimer [*]	0	0	0	0	1	1

Emphasis of Matter[#]

Emphasis of matter⁴ (EOM) paragraphs are still used, but are now much less common. Examples of the matters now reported under the heading of EOM include “Basis of Preparation” and “Investment in Related Entities”.

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 auditor to include additional information in the description of the KAM.

Disclaimer^{*}

A KAM section is not included in the auditor’s report when a disclaimer of opinion is issued. For this reason, the analysis below excludes the disclaimer of opinion.

⁴ An emphasis of matter paragraph is a paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial statements.

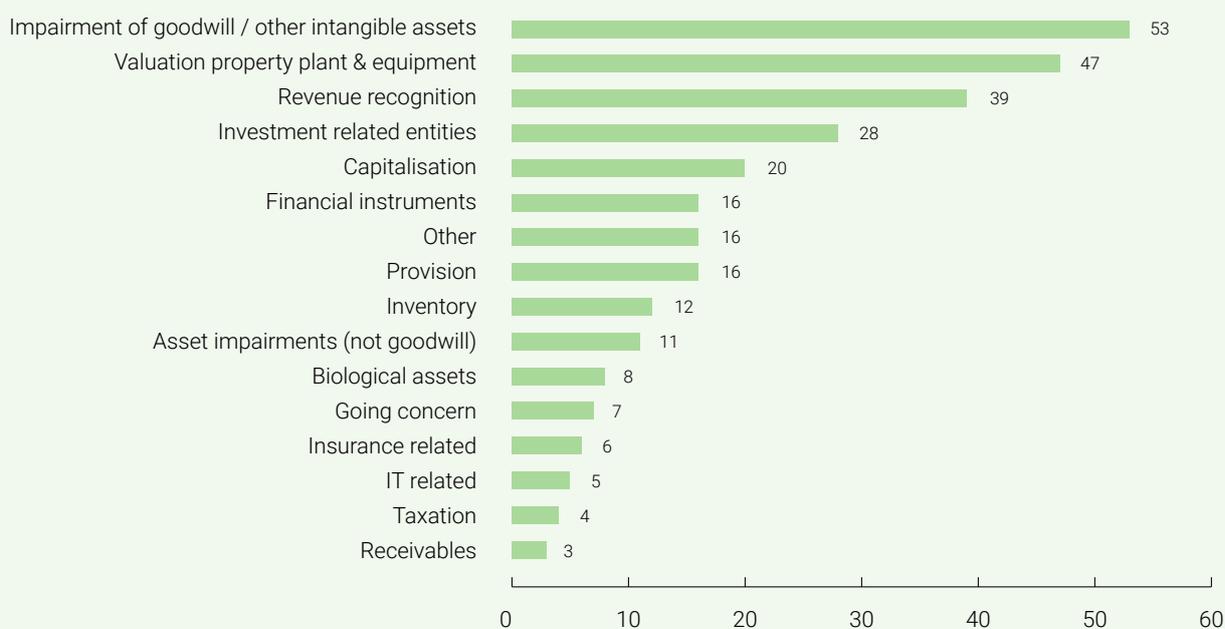
Reporting of KAMs



Most common KAMs

The table below highlights the most common KAMs reported.⁵

Number of times KAMs reported



Detailed analysis of the types of KAMs by sector is provided on pages 22-23.

The most common KAMs reported are as we expected given the structure of the New Zealand market. Impairment of goodwill and other intangible assets and investments in related entities are regularly reported as KAMs in many industries, as a result of business combinations.

Other common KAMs such as valuation of property, plant & equipment and capitalisation are linked to industry specific developments.

- Valuation of property, plant & equipment is the most common KAM in the commercial property sector. This is largely due to the judgement and assumptions involved in the valuation of investment and development properties, and the significance of the assets in the entity's balance sheet.
- Capitalisation is mainly seen in the information technology sector, which is a growing sector in New Zealand. This KAM is commonly linked to internally developed intangible assets. These require significant judgement as a result of technology development and revenue pressure from new players in the local and international market.

⁵ Judgement has been exercised in categorising these KAMs. When selecting the categories we have taken into account similar reports about KAMs.

The overall New Zealand results are in line with the international experience. However, taxation is a common KAM in other jurisdictions but only appeared in four examples in the New Zealand sample. Our subsequent discussion with directors highlighted that they expected to see more KAMs on taxation.

Observation about the use of auditor experts

39 (44%) of the auditors' reports surveyed referenced using auditors' experts or specialists.

The most common specialists to be used in the audit were in-house valuation specialists. These specialists appeared in 22 of the KAMs reported under valuation of property, plant & equipment and 11 in impairment of goodwill / other intangible assets.

The commercial property sector used the most experts, referenced in 36% of the reports.

The evolution of KAMs

Our analysis showed that the way in which KAMs are reported is already changing, even within the first year of adoption. We expect this evolution to continue over time. The aim is to produce an auditor's report that increases the users' understanding of the KAMs and how the auditor has dealt with those matters.

More recent reports clearly explained the judgements associated with the KAMs, linking the KAM specifically to the entity's performance, industry or sector performance or the economic risk associated with the KAMs. More details were also provided concerning the entity's valuation method and assumptions used, making the explanation of the KAMs more meaningful and logical. We consider that this enables a better understanding of why the matter was considered a KAM.

We consider that auditors are using simpler and easier language to explain the procedures they have performed over the KAMs. In some cases, the auditors have provided

more details on the procedures by disaggregating them to a step by step audit approach. Some even disclose the range of the sensitivity analysis they felt comfortable with. For more frequently reported KAMs, for example impairment of goodwill and valuation of property, plant and equipment, auditors have included greater detail. This may be to meet the objective of increasing users' understanding of the KAMs.

Presentation of the KAMs

The majority of auditor's reports used a tabular format, clearly presenting each KAM, why it is considered a KAM, and an explanation of how the audit addressed the KAM. One of the auditor's reports reviewed went further with their design, and included clear diagrams to help the reader understand the scope of the audit, and the extent of testing across the group.

We expect to see the presentation style of KAMs to continue to evolve. Feedback in the UK has been that investors praise the auditors' reports that are well structured, signpost key information and make innovative use of graphics, diagrams and colour.

The majority of users interviewed stated they were looking for a clear explanation from the auditor of why a matter was identified as a KAM.

KAMs of interest

Our interviews found a number of KAMs of interest to users, including:

- Non-financial KAMs.
- KAMs linked to the entity's strategic goals or wider macro-economic or environmental factors.
- KAMs highlighting the reliance of the entity and the auditor on complex IT systems and controls (including the auditor having to rely on the IT environment of the entity).
- KAMs where the outcome of audit procedures is reflected and the additional procedures performed to address those outcomes.



Going concern as a KAM

Going concern can be a sensitive matter, and is an area where there have been calls for greater auditor attention. The revised auditing standards promote greater auditor emphasis on disclosures in the financial statements, and have amended the way in which an auditor may communicate matters related to use of the going concern assumption.

There are two different communication approaches where the audit opinion is not modified but the auditor still reports going concern matters. The approach depends on whether the auditor concludes that there is a material uncertainty related to going concern (MURGC) or not. These different approaches are illustrated in the table below and highlight the complexity, subtlety and variation in dealing with going concern issues.

Where the auditor concludes that there IS a material uncertainty related to going concern (MURGC)

A material uncertainty related to going concern is, by nature, a KAM but is communicated in a separate section in the auditor's report.

There have been 16 examples where the auditor has concluded there is a MURGC.

Where the auditor concludes that there is NOT a material uncertainty related to going concern, but the use of the going concern assumption is identified as a KAM

Going concern can be "close-to-call". In this situation, the auditor may have spent significant effort to gain comfort that the use of the going concern assumption was appropriate. Where the auditor concludes that a material uncertainty does not exist, communicating a KAM related to going concern may be difficult. This type of information has not previously been reflected in the auditor's report.

There were seven examples of KAMs on going concern.

Even though identifying going concern as a KAM may be a sensitive matter, we note that some of these KAMs also included the outcome of the audit procedures. This is discussed further below.

Alternatively, the auditor may modify the audit opinion where there is a lack of audit evidence to support the going concern assessment, or where the appropriate disclosures are inadequate in the 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 auditor provide an indication of the outcome of the auditor's response. The auditing standards preclude auditors from providing discrete opinions on separate elements of the financial statements.

Some auditors are voluntarily providing more detail about the audit response to a KAM and include the outcomes of the audit procedures. There is variation in the level of detail provided. Such reporting is evolving over time, some reports provide outcomes by audit procedure, whilst others include a single statement about the overall outcome by KAM. Firms are avoiding providing discrete opinions. Some do not include any outcomes of audit procedures.

Some examples of the outcome of audit procedures:

"... in line with our expectations."

"... found no evidence of bias."

"we found no material errors in the amounts..."

"...the estimated useful lives of assets were within an acceptable range when compared to those used in the industry."

Stakeholders have mixed reactions to such voluntary disclosures:

For	Against
<p>It avoids leaving the communication of the KAM “hanging”.</p> <p><i>Reported by auditors</i></p>	<p>Outcomes on individual matters can be misconstrued as a separate opinion and detract from the auditor’s opinion on the financial statements as a whole.</p> <p><i>Reported by auditors and directors</i></p>
<p>The additional transparency and insight is valuable, enabling the auditor to tell the story, making the report easier to read and understand.</p> <p><i>Reported by auditors and directors</i></p>	<p>Too risky.</p> <p><i>Reported by auditors</i></p>
<p>Some entities have preferred that the auditor’s report close the communication of a key audit matter out, otherwise consider that the reader is left asking “so what?”.</p> <p><i>Reported by auditors and directors</i></p>	<p>An unmodified opinion reflects that the auditor has concluded that there is no material misstatement. Reflecting the outcome of specific audit procedures is not needed.</p> <p><i>Reported by users</i></p>
<p>Considered useful transparency that is in keeping with the aims behind the change.</p> <p><i>Reported by users</i></p>	<p>Users may read too much into the outcome of specific audit procedures.</p> <p><i>Reported by auditors</i></p>
<p>Because the auditor’s report has drawn specific attention to a matter, this creates the need for some reassurance that this is not an issue, and not been resolved by the auditor.</p> <p><i>Reported by users</i></p>	<p>It is not necessary as KAMs are not a substitute for a modified opinion.</p> <p><i>Reported by auditors and directors</i></p>

Some auditors commented that including the outcome of the audit procedures may provide the auditor with some additional leverage, enabling the telling of a story. For example, a change in the auditor’s language may signal a change in the circumstance of the entity and is therefore more insightful and useful for the user.

An example identified by a director was where the outcome of audit procedures relates to impairment. There are two different scenarios that highlight why including the outcome of audit procedures in this example was seen as helpful. A statement that the assumptions were aggressive and then later resulted in a recognition of a loss tells a more complete story. On the other hand, it may also be useful to address

concerns that there should not be a KAM where there is a lot of headroom. If the outcome of the audit procedures explain that the auditor found the assumptions to be within the acceptable range, it demonstrates that even though the auditor spent a lot of time on this it is not necessarily an issue for users.

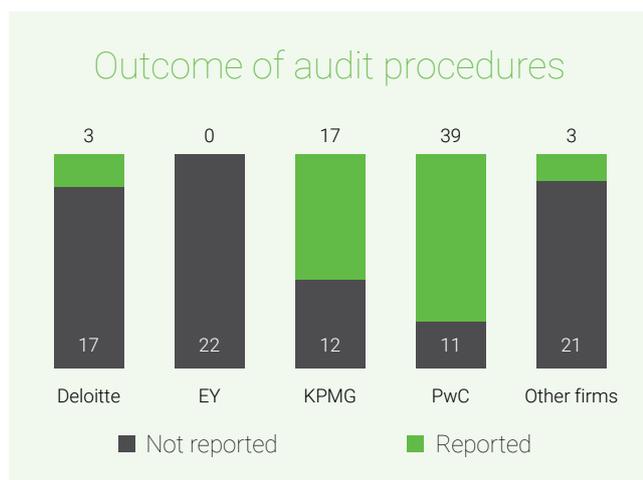
The users who did not have a strong view as to whether reporting of outcomes should be mandated generally understood that the audit opinion had not been modified and therefore understood that with or without a closing remark the KAM reported had not had an impact on the opinion overall.



We encourage innovation in this area, however care needs to be taken to ensure the report does not inappropriately include a separate opinion on elements of the financial statements. It is particularly important that users of the report are not confused by or interpret any outcomes to imply that a separate opinion on an individual line item of the financial statements has been given.

Our analysis found that different approaches have been adopted by different firms. In most cases, PwC and KPMG have reported the results of the procedures performed to address the risk. However, this has not been consistent as demonstrated below. The level of detail in such statements is also changing over time. Deloitte has reported the outcomes of audit procedures in only two auditor’s reports. EY and other mid-tier firms have chosen not to disclose the outcome of their audit procedures.

The table below shows the number of instances where the firm has included the outcome of audit procedures.



The IAASB and the XRB are monitoring practice and will consider this as part of the planned post-implementation review of the new and revised auditing standards. Early feedback is mixed. There is no consensus amongst stakeholder groups and no clear preference expressed. Although, there were some requests for consistency from users we spoke to.

The impact on directors and preparers

A key message we heard was the need to engage early.

The experience to date was positive from all directors we interviewed.

What we heard:

- The new report is viewed as an improvement.
- The process has generally been well managed, from the “dry run” through to the enhanced reports.
- Directors commented that the reporting of KAMs has increased director engagement, and has resulted in focussed and early discussion on key areas. Whilst these conversations have occurred in the past, KAMs have brought a new level of focus to the discussions.
- Preparers and directors appreciated early engagement with their auditors. This ensured sufficient time to discuss the identification of KAMs as well as consider and adjust any wording in either the financial statements or the auditor’s report. This alleviated much of the anxiety about the new report and avoided adding pressure to tight reporting deadlines.
- The enhanced reporting requirements have not impacted the reporting timelines, even though this had been a concern of some preparers. This is probably attributable to good planning, engaging early, a no surprises approach and the benefit of the “dry run” process.
- There has been good co-operation in aligning wording in the financial statements and the description of KAMs. Some respondents noted that the process has resulted in minor improvements made to the disclosures in the financial statements.
- The KAMs identified align somewhat with the drive to “cut the clutter” in the financial statements. The process is helping to identify judgements and assumptions that may not be particularly significant in understanding the financial statements and could therefore be left out.

- We heard limited experiences of contentious KAMs.
- There has been an increase in the focus on audit differences.
- While the identification of some KAMs have been obvious, others have required “healthy debate”.

Some directors and users expressed concern about whether a KAM was always needed.

Auditors expressed surprise that there was less debate and contention than originally expected around the identification of the KAMs or the wording used in the auditor’s report. This may be due to the current positive business environment, which is contributing to fewer sensitive KAMs.

It will be interesting to see whether the wording selected by the auditor will be subject to greater debate through the economic cycle. Pre-planning has helped too.

The positive feedback we have heard from directors recognises the huge effort that the audit profession has invested in the process.

Directors we spoke to were very supportive of increasing transparency, making what has always been reported to the audit committee more visible to the user.

Is there always a KAM?

It is envisaged that, for an audit of listed entities, there will be at least one matter that received significant audit focus and discussion with the audit committee. A rare exception may be where a listed entity has very limited operations. In these circumstances, the auditor’s report would indicate that there were no KAMs to communicate.

The impact on auditors

What we heard from practitioners:

Benefits	Time/Cost
Helped the audit team to define the risks and focus the effort and attention on the key areas.	A four-level review process is common practice for all auditors’ reports that have included KAMs. This involves more time from senior staff.
<p>The new approach has allowed auditors to closely scrutinise the key audit areas. They have also implemented additional internal review processes. Together these have contributed to:</p> <ul style="list-style-type: none"> • Consistency between KAM and entity’s disclosures about underlying judgements and assumptions. • The focus on whether the auditor has done and clearly documented what they say they have done. • Consideration of whether further work was needed. 	<p>The need for technical expertise to ensure that the requirements of the auditing standards have been met continues to grow. There are areas of the new reporting requirements that are technical and for which technical support is needed. Auditors commented that they rely on this technical resource, and would not like to report KAMs without it. While there may be less need for such intensive ongoing implementation support, many auditors did consider that there will continue to be a need for risk management support.</p>



Benefits

KAMs have had an impact across the audit process, starting at the planning stage. It is here that the most benefit has been seen from the auditors' perspective – having focused the audit team's efforts.

Time/Cost

The "dry run" process took time and was done to "educate" and address the anxiety originally felt by auditor, director and preparer surrounding the new report.

There is a perception that the new requirements increase the litigation risk to the audit firm and as a result the firms have developed further internal review processes.

The firms have invested a huge amount of resource and effort into the new reporting requirements. Auditors we interviewed estimated that the additional time incurred was between 40 to 60 hours of senior people's time. Practitioners and directors we interviewed noted that the audit fees had not gone up to cover this cost.

Auditors raised concerns about the implementation of the changes when applied to the second wave of mandatory adopters, the other FMC reporting entities considered to have a higher level of public accountability from 2018 relating to:

- The costs of implementing KAM for such entities may amount to as much as the whole audit fee.
- Time and supply pressures given that there will be a large number of March year ends in the second wave, increasing demands on a limited number of licensed auditors all at the same time.

We note that it is early days, too early (and very difficult) to determine the impact on audit quality.

What advice do auditors have for those that have not yet reported KAMs?

Do not underestimate the time required to:

- Identify and document matters that required significant auditor attention and the rationale for the determination as to whether those matters were to be identified as a KAM.
- Manage more participants in the process, including the engagement team, client management and audit committee, and the internal review process.

- Write simply on technical matters. The audit firms are mindful that the objective is to engage more with the user of the auditor's report. Auditors admitted they had gone through a huge learning curve. Those interviewed are getting more comfortable with the new communication requirements, and are getting better at communicating more clearly, using less technical language.
- There is a need to streamline the work flow further. Currently, there is considerable redrafting – the initial audit work papers are rewritten for audit committee reports and later redrafted for the KAM report. There is an opportunity to write the initial audit work papers in less technical language to streamline the process.
- While it is recommended to engage the audit committee early to discuss the identification of KAMs, practitioners caution against fixing the KAMs too early as they may change as the audit progresses.

The impact on users

There was a mixed response from users, ranging from very positive to indifferent or unaware of the change. This highlighted that it is still early days in terms of exposure to and engagement with the new auditor's report and that the expectation gap remains.

We did hear positive feedback from some users that have started to engage with the revised report that they are now more likely to read the auditor's report.

“More information from the auditor gives additional comfort that the auditor understands the important matters and has addressed them.”

“KAMs point the reader to what was important for the auditor. Usually this is obvious but there may be instances where it is not, and this will be really useful.”

Others were of the view that it is not the auditor’s job to add more information, rather they were just looking for a tick or a cross overall. Moving the audit opinion to the front has therefore been well received.

From the feedback we heard we consider that some users need more information about what KAMs are to better understand the communicative value of the revised reports.

Some misconceptions we heard were that users considered that:

- KAMs are an alert to users of the “issues that need to be resolved”.
- Users would gain more comfort from an auditor’s report with a fewer number of KAMs, as this may indicate that it is a better company with fewer issues.

Perceptions such as these illustrate the need to continue to educate users about the nature and purpose of KAMs. Some of these KAMs will be recurring matters given the nature of the entity, the necessary audit effort or the accounting requirements.

Very few auditors or preparers have had any feedback from users about the KAMs reported. The AGM is a good opportunity for users to ask questions and gain insight.

The audit firms and engagement partners are dependent on feedback from investors and other users of the auditor’s report to inform them about the usefulness of the new format. They require feedback on what was most useful and what was of less use to help them evolve the reporting in the future.



Voluntary reporting in the auditor's report

Our analysis identified that auditors have implemented the new requirements and, in some cases, have gone beyond what is required by the auditing standards. Each of the audit firms have adopted different approaches to the new auditor's report. This diversity is encouraging as the objective of the new requirements is to move away from a boilerplate auditor's report, and increase the relevance and usefulness of the auditor's report. Below we look at the additional reporting areas that some audit firms are voluntarily including beyond

the mandatory New Zealand and international requirements. Through our interview process we queried the drivers behind the additional reporting and why this reporting was included.

Additional information has been provided in the following areas:

- Materiality.
- Broader explanation of the audit scoping process.
- Disclosing the outcome of audit procedures with respect to KAMs reported (which is analysed on pages 11-13).

How does New Zealand compare to other jurisdictions?

The requirements in some jurisdiction go further than the international auditing standards that have been adopted in New Zealand. Globally we are seeing variation in the following areas:

	Materiality	Audit scope	Outcomes of procedures
UK	Required	Required	Voluntary First year 2% ⁶ Second year 20%
Singapore ⁷	Voluntary First year 1% disclosed	Voluntary First year 2% disclosed	Voluntary First year 50% indirectly provided outcomes
New Zealand	Voluntary First year 61% disclosed	Voluntary First year 37% disclosed	Voluntary First year 43% disclosed

Our analysis shows that there has been a high level of voluntary reporting in New Zealand.

As the first "new form" auditor's reports issued globally were from early adopting jurisdictions, the New Zealand firms have been able to benefit from the learnings of these early adopters. Some firms have seen the value of including additional contextual information, and other firms raise concerns that additional information may be confusing for the reader.

While some users expressed the desire for consistency between reports, others felt the new report is meant to be entity specific rather than boilerplate, and they encouraged the auditor to be experimental.

We see the reporting of voluntary information as a key part of the transition journey. The IAASB will be conducting a post implementation review to assess the benefits and costs of these additional disclosures in the near future.

Materiality

The concept of materiality is fundamental to the audit. Materiality is applied by the auditor when planning and performing the audit. Materiality is also applied when evaluating the effect of identified misstatements on the financial statements. It is critical in forming the audit opinion.

⁶ Financial Reporting Council (2016, January) Extended auditor's reports: A further review of experience.

⁷ ACCA ACRA, ISCA and NTU (2017, October) Embracing Transparency, Enhancing Value: A first year review of the enhance auditor's report in Singapore.

Materiality is a financial reporting concept, so is not defined in auditing standards. Reference to materiality is related to:

- Misstatements (including omissions) which could influence decisions of users.
- Judgement based on the circumstances including the size and nature of the misstatement.

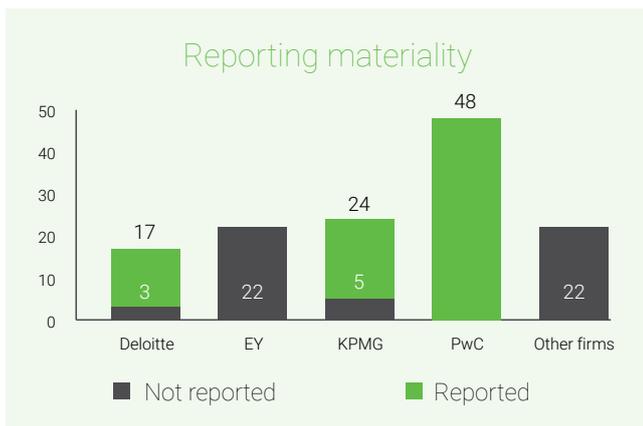
What information is reported about materiality?

New Zealand follows the international standards and the auditing standards do not require the auditor to disclose information about materiality.

However, in other jurisdictions (for example, the UK) – there is a requirement to explain how the auditor applied materiality in planning and performing the audit, requiring that the materiality level used be explicitly stated. This was included to give more context to the key risks that are reported. Such reporting has set an example that some New Zealand firms have chosen to follow. We found some variation in what is disclosed, including:

- a. Materiality benchmark.
- b. Rationale on the chosen benchmark.
- c. Materiality value.
- d. Materiality percentage.
- e. Threshold for reporting unadjusted errors to the audit committee.

The analysis below shows the approach taken by the main firms on disclosing information on materiality (excluded disclaimer opinion).



PwC and KPMG disclose most of the above elements in their auditors' reports. For example, PwC has reported the materiality benchmark in 48 reports, KPMG in 22 reports and Deloitte in one report.

Deloitte only disclosed the materiality level without providing any further detail over the benchmark and percentage used. When asked why in the interviews, we heard that the auditor uses a significant degree of judgement to determine the benchmarks to be used for materiality and it may be influenced by a number of factors. Capturing this judgement in a succinct and non-technical manner that is clear to the user can be very challenging. In many instances determining materiality is not as simple as applying a 5% of net profit benchmark.

Other firms are purposefully excluding information about materiality given that this is not required by international and New Zealand auditing standards.

We noticed that in some circumstances the magnitude of unadjusted differences being reported to the audit committee have been disclosed. PwC has reported in 16 reports and KPMG in two reports. We heard that this is often client driven. Additional information may be included to relieve concerns where the reported materiality levels seem high.

Benchmarks A wide range of benchmarks are being used by auditors in their application of the concept of materiality, as appropriate to the specific entity. The use of different benchmarks demonstrates the significant degree of judgement that is used by the auditor. The auditing standards do not mandate any benchmark that should be used in setting materiality. Normally the materiality benchmark is driven by the entity specific performance or operating environment. As a result, entities operating in the same industry might use a different benchmark.

The benchmarks reported include: profit (loss) before tax and adjusted profit before tax, revenue and adjusted revenue, total assets, net assets, expenses and total equity.

The most common benchmark reported is profit before tax. The rationale offered was that it represents a key measure of performance of the entity and is a commonly accepted benchmark.



Support for including materiality:

Improves transparency of what has been reported to the audit committee.

May help to address the expectation gap of some users, reminding them that auditors are not going to qualify the opinion for every minor error found.

Where the benchmark is identified and well explained, it provides a good level of context.

Makes the auditor's report easier to read.

Concerns expressed about including materiality:

May be overly simplified if just the materiality number is reported. Users may need to understand more about the benchmark used and why that benchmark was considered to be appropriate.

Materiality is a judgement, not just a simple mechanical process. As such, it is difficult to describe that judgement in a succinct way that will always be well understood.

There is a risk that it could add confusion or potentially be misunderstood.

Directors' and investors' perspectives. Some directors and investors were indifferent as to whether materiality should be included in the auditor's report. More experienced investors, such as analysts, expressed the view that as there is generally a standard way of establishing materiality, it can often be determined without being explicitly reported. Some directors noted that materiality is not a contentious issue, and has been reported to boards each year.

There were also others who expressed a preference for consistency across auditor's reports.

Audit scope

Some firms have decided to include a description of the audit scope related to consolidated financial statements. PwC has included this in 47 reports and KPMG in six reports.

Our analysis found that those firms that include information about the audit scope include a generic explanation of the scope. However, there have been a few cases where the auditor has gone beyond this and provided a clear description of the areas of focus. They linked KAMs and materiality and provided a description of how these influenced the scope of the audit.

In one case we have seen the use of visual charts to illustrate the audit scope.

Some of those examples include:

"Our Group audit scope focused on the major operating locations which were selected as they contribute more than 5% of either the Group's revenue or profit before tax. In aggregate, the locations selected contribute 85% of the Group's revenue and 95% of the Group's profit before tax."

"The consolidated financial statements are a consolidation of five subsidiaries; all based in New Zealand but some with separate finance functions. To obtain sufficient evidence over the Group components we scoped our audit to obtain coverage and comfort on a financial statement line item basis, including performing risk assessment procedures. All audit procedures were conducted by the Group audit team."



Early adopters

Learnings from early adopters

14 entities adopted the standard before its effective date.
11 of these have issued their second report.

About the journey. In our interviews we heard that the drivers for early adoption were largely client driven. Some audit clients embraced the opportunity for increased transparency, and therefore requested that the auditor early adopt the reporting of KAMs. Other early adopters are entities already known for their leadership in financial reporting.

We heard of one instance where the auditor presented an illustrative ‘mock’ new form auditor’s report to explain the new requirements to their client the year before it became mandatory. This illustration was so well received that it led the client to request the auditor to early adopt the requirements.

Does it get easier? All involved have found the process easier in the second year of implementation. Audit firms have learnt a great deal from their first-year experience, whether it was as an early adopter, or from running “mock” trials of what such a report would look like.

Key learnings have been around the use of language. Auditors are getting more comfortable using less technical wording and focusing on the needs of the user.

We heard that the number of hours taken to draft the auditor’s report also reduced the second time around, as all parties better understood the process of reporting KAMs. Estimates provided indicate that the number of hours required was less than half that of the first year of implementation. However, there will still be ongoing time and additional cost required to adjust and enhance reporting to maintain the relevance of the KAMs.

The auditors identified that the challenge going forward will be to avoid boilerplate language, to continue to enhance the relevance of the report. Various stakeholders expressed a concern around boilerplate language creeping in over time.

New Zealand is still early in the process of reporting of KAMs. The financial reporting environment is generally stable and therefore the same matters are likely to arise as KAMs. However, experience in the UK suggests that auditors have worked hard to avoid boilerplate language and to provide

information that is relevant and useful for users. We hope this will also be the New Zealand experience.

What has changed in the second year

Our analysis of those 11 companies where the auditor has already issued two of the new style auditors’ reports shows change in the following areas:

Reported KAMs. The type and number of KAMs reported for an entity have not changed in most cases. This is expected as the sector, business environment, and the areas that require significant auditor attention will be consistent year on year for most entities. However, in two circumstances we noted that the KAMs had either completely changed or had partly changed from the first year. Some of the examples of KAMs which changed from year to year were those related to legal provisions, new IT systems implemented during the year, and business acquisitions.

KAMs may change as the economic and business environment changes. It is expected that if an entity’s areas of focus change the KAMs will also evolve.

Description of KAMs. Our analysis showed only minor improvements were made to the description of KAMs. In one case, the auditor tailored the description of the KAM on “Capitalisation” specific to the audited entity. In this example, the description improved by referring to the impact of the technological change on evaluating the assets’ lives, and the judgement needed to determine whether the expenditure enhanced the asset (therefore capital) or maintained the current capability (expenses).

In some cases the order of the information changed to help users’ understanding with a more logical flow.

Audit procedures. In some cases, auditors have added additional context to emphasise the purpose of the procedures performed such as to “assess valuation and accounting treatment”, or “assess accuracy of the KAM”. We note that specifying the purpose of the procedures does not mean that the audit work is limited to that specific area, but provides a clear linkage between the KAMs and procedures performed.

Our analysis also found one example where the audit procedures changed in the second year on the same KAM.



Future focus

The reporting of KAMs has been a notable change and we expect the reporting to continue to evolve.

FMA focus

The FMA will review audit files to assess the process followed by the audit firm to determine the KAMs, and whether the audit work performed fairly reflects the disclosure in their auditor's report. As each business is different and auditors will apply their individual judgement to their reports, we expect to see KAMs that are specific to individual businesses. The FMA will also use the information obtained from these reports as a basis for selecting its audit files subject to audit quality review.

In the first years of implementation we will work with audit firms to help them provide clearer and better auditors' reports that give investors and other users of financial statements the most relevant information.

XRB focus

The XRB will continue to monitor the implementation of KAMs, especially from December 2018, when the second wave of implementation takes effect for other FMC reporting entities considered to have a higher level of public accountability.

Information gathered during interviews conducted in preparing this publication and ongoing monitoring of implementation issues will be considered as part of the post implementation project to be run internationally. The XRB intends to participate in this review, as well as monitoring New Zealand specific implementation.



Appendix 1:

Most common KAMs by sector

Sector	No of entities	Asset impairments (not goodwill)	Impairment goodwill / other intangible assets	Inventory	Investment in related entities	Revenue recognition	Valuation Property Plant & Equipment	Capitalisation
Agriculture	12	2	5	2	-	2	3	-
Commercial properties	15	-	2	-	2	4	17	2
Construction	2	-	2	-	1	2	-	-
Consumer Goods & Services, support services and retail	28	2	18	9	11	9	4	3
Energy	8	-	1	-	2	2	8	1
Financial services	10	1	3	-	1	1	-	-
Health Care	8	-	5	-	1	2	-	1
Industrials and basic materials	5	-	3	1	2	-	-	1
Information Technology	14	2	6	-	-	10	-	10
Investment	16	2	1	-	6	-	5	-
Investment funds	3	-	-	-	-	-	-	-
Metals & Mining Oil & Gas	4	1	-	-	1	1	2	-
Other	4	-	2	-	1	1	3	-
Telecommunication and Communication	5	-	3	-	-	3	1	2
Transportation	8	1	2	-	-	2	6	-
Grand Total	141	11	53	12	28	39	49	20

Going concern	Insurance related	Biological assets	Provision	IT related	Other	Financial instruments	Receivables	Taxation	Grand Total
-	-	7	2	-	1	-	-	-	24
-	-	-	-	-	1	-	-	1	29
-	-	-	-	-	-	1	-	-	6
2	1	1	2	-	3	-	2	1	68
-	-	-	-	-	2	3	-	1	20
-	5	-	6	4	-	4	1	-	26
1	-	-	1	-	3	-	-	-	14
1	-	-	-	-	-	-	-	1	9
1	-	-	-	-	2	-	-	-	31
2	-	-	1	-	2	4	-	-	23
-	-	-	-	-	-	2	-	-	2
-	-	-	-	-	-	-	-	-	5
-	-	-	1	-	1	1	-	-	10
-	-	-	1	1	1	1	-	-	13
-	-	-	2	-	-	-	-	-	13
7	6	8	16	5	16	16	3	4	293



Appendix 2: Other changes

In addition to the inclusion of KAMs, the new auditor's report includes further additional changes:

Key change	Reason for the change
Going concern	
<ul style="list-style-type: none"> • Descriptions of the respective responsibilities of management and the auditor for going concern are included in the auditor's report. • A separate section under the heading "Material Uncertainty Related to Going Concern" must be included when a material uncertainty exists and is adequately disclosed. • New requirement for the auditor to evaluate the adequacy of disclosures in "close call" situations, when events or conditions are identified that may cast significant doubt on an entity's ability to continue as a going concern but no material uncertainty is concluded. 	<p>Going concern is of significant interest, particularly following the global financial crisis. It is in the public interest for there to be increased focus on going concern matters by management and auditors.</p>
Auditor's Independence and Ethical Responsibilities	
<p>Affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities.</p>	<p>Emphasizes the importance of complying with ethical requirements as a basis for the audit and increases the focus on auditor independence.</p>
Disclosure of Name of Engagement Partner	
<p>Disclosure of the name of the engagement partner for audits of financial statements of FMC reporting entities considered to have a higher level of public accountability.</p>	<p>Increases transparency and provides the engagement partner with a greater sense of personal responsibility and accountability. The objective of the change is to improve audit quality.</p>
<p>Another aspect that users responded to positively was the requirement to identify the engagement partner's name. Some users commented that this enhanced their comfort and added to the credibility of the audit opinion.</p>	
Ordering of Sections	
<p>The "Opinion" section is required to be presented first, followed by the "Basis for Opinion", unless law or regulation prescribe otherwise.</p>	<p>Recognises the importance of the auditor's opinion on the financial statements to users.</p>
<p>"Good to have the opinion upfront". A key point noted from users is that they value the audit opinion, this is of most importance. In fact, this is what they really look for from the auditor – a tick or the cross – i.e., is the opinion modified or not. Having this opinion stated upfront in the auditor's report is therefore a good move in meeting user's needs.</p>	

Key change	Reason for the change
Other information in documents containing financial statements	
A new and separate “Other Information” section clarifies that the auditor’s opinion does not cover the other information, but describes the auditor’s responsibilities related to the other information, identifies what information was obtained at the date of the auditor’s report and what information is expected to be obtained at a later date.	Provides transparency about the auditor’s work relating to other information.
Enhanced Description of the Responsibilities of the Auditor	
Description of auditor’s responsibilities for the audit and key features of the audit have been enhanced and expanded.	Provides greater transparency of the audit process and provides enhanced understanding of the role of the auditor and the nature of audit work. The revised standard is more flexible as to where this information is located, and now permits this information to be located in an appendix or included by reference to a website that is maintained by the XRB.

Reference to auditor’s responsibilities

Our analysis found that in most cases the auditor’s preference was to reference those responsibilities to the XRB website (78% of the reports).

Other information

The new “other information” section is now included to clarify what part of the annual report has been audited. The new section outlines the auditor’s responsibility for other information in the annual report (i.e., other than the financial statements and the auditor’s report).

These changes are proving to be challenging in practice. Auditors we interviewed told us that they are grappling with how to describe what information has or has not been read for consistency at the date of the auditor’s report. This has raised queries about what the auditor’s responsibilities are

in relation to the other information – “what does read for consistency mean”.

Directors we interviewed noted that a positive impact of this change has been that the annual reporting timetable has been brought forward in some instances. This has resulted in the annual report being published at the same time as the financial statements reporting deadline.

Placement of the auditor’s report

The auditing standards do not stipulate where the auditor’s report is to be included relative to the financial statements. With the enhanced focus on improving the value of the auditor’s report to the user, we hope the positioning of the auditor’s report is given greater consideration. Our analysis found that there is currently variation in practice, with most annual reports including the auditor’s report after the financial statements.

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