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STRATEGY SPOTLIGHT

Enhanced auditor reports off to promising start but risks need watching

Key audit matters should continue to be company specific and should not revert to becoming generic over time. BY THEMIN SUWARDY AND MELVIN YONG

SINGAPORE-LISTED companies have to guard against the risk that the new enhanced auditor reports that took effect about nine months ago may one day return to generic boilerplate language, according to professional services firm KPMG.

This warning comes even as the experience on enhanced auditor reports has been positive overall so far, with issued documents containing descriptive and entity-specific information.

For audit reports issued on or after Dec 15, 2016, the disclosure of so-called key audit matters (KAM) has become mandatory for listed companies.

The audit opinion letter that comes with companies' annual reports has seen a transformation.

"The audit reports issued during this first year moved away from the historic boilerplate reporting, with generally a binary opinion to providing better and more information about judgments made by management on KAM and the approaches that the auditors had adopted," said Roger Tay, partner and head of audit at KPMG Singapore.

No longer are auditors just giving a "pass or fail" opinion on company financial statements but the reports have become entity-specific discussions that shed light on the audit process and the key judgments applied in arriving at the conclusions.

Board directors also feel that KAM has facilitated quality conversations with company executives.

"KAM is more helpful for shareholders as it summarises the difficulties encountered by both the company's finance team and its external auditors in addressing matters that may have financial impact on the financial accounts like valuation of investments. These are summarised clearly and concisely in the auditor report," said Steven Lim, chairman of Sapphire Corporation.

"Audit committees depend, to varying extents, on management and auditors to surface the relevant audit issues and through such disclosures, we will know if there are any material areas that require further scrutiny," said UOL audit committee chairman Low Weng Keong, who also sits on the boards of a number of listed companies.

Most common KAM

KPMG's research on enhanced auditor reporting shows that the most common KAM relate to carrying amount for assessments of assets including goodwill, intangible assets, investment properties and revenue recognition.

"This is not a surprise, given that these assessments involve significant amount of judgment and estimates, and the application of which usually has a significant effect on the financial statements," said Mr Tay, whose team is producing an upcoming study on enhanced auditor reporting that looks at the experience of Singapore, London, Australia and Hong Kong.

"We have observed a fairly consistent average number of KAM and types of KAM issued across various markets that are adopting the enhanced auditors report for the first time, including Australia and Hong Kong," said Mr Tay.

"In addition, some firms have taken a step further in disclosing and commenting on the findings arising from their audit procedures performed," he added.

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KPMG said that while a number of reports voluntarily included the audit findings to each KAM, only about one-third had specific commentaries on management's judgments and specific errors. The rest contains fairly generic descriptors such as "reasonable", "within an acceptable range" and "appropriate".

"It is important that KAM continue to be company specific and do not become generic over time," said Mr Tay.

He said this will require the support of regulators, auditors, preparers and audit committees to ensure that the good progress made in the first year of implementation does not lose momentum and innovates the process by which auditors communicate to users of financial statements.

Investors too have taken notice of the types of information that are disclosed especially if such disclosures could affect their investment strategy.

"KAM allows analysts to identify from the financial statements what they know, what they don't know, what they somewhat know and what they cannot know," said OCBC Credit Research.

OCBC noted that KAM could potentially help analysts understand the more tricky elements of an organisation's financial statements, which allows them to identify the areas where there may be potential variance between values reported in the financial statements and realised values.

As an auditor, KPMG said the enhanced auditor report has facilitated deeper and more detailed dialogues with management, audit committees and board directors on the audit.

Greater transparency

The disclosures in KAM increase transparency on the audit process and allow management, audit committees and board directors to understand the key issues, judgments and estimates made to derive the conclusions, said KPMG.

Citing his personal experience as a director, Mr Low said while KAM is a new disclosure requirement, the companies that he has been involved with and their auditors have always understood the need to discuss key audit issues in the planning and reporting stages of an audit and so does not introduce new audit work.

"What KAM disclosure does is to put the spotlight on the need to have open and frank discussions on how auditors go about doing their work and arriving at their eventual audit opinion on such matters," said Mr Low.

But there is room to improve.

OCBC Credit Research said, based on a sample of KAM statements it has seen, there does not appear to have been much discussion about off-balance- sheet items.

These include joint ventures and associates, even if these are a material part of the balance sheet and earnings, as well as contingent liabilities and corporate guarantees.

Still, observers say further baby steps will lead to greater outcomes as the enhanced auditor reporting process matures.

"We are optimistic that this is just the beginning of better communication between all stakeholders in the preparation and audit of financial reports," said Mr Tay.

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