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Users of the financial statements have signaled that the auditor's opinion on the financial statements is valued, but that the auditor's report could be more informative. They have called for auditors to provide more entity-specific and relevant information to users in their auditor's reports based on their audits. The IAASB's work to develop new **ISA 701**, [Communicating Key Audit Matters in the Independent Auditor's Report](#), responds to this call and is at the heart of the enhancements to the auditor's report arising from the IAASB's [new and revised Auditor Reporting](#) standards. This publication has been developed to assist investors, preparers of financial statements, those charged with governance (TCWG) and others interested in understanding key aspects of KAM as set out in ISA 701.

Selected from matters communicated with those charged with governance, Key Audit Matters or "KAM" are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

Communication of KAM in the auditor's report will be required for all audits of listed entities conducted in accordance with ISAs.

What Are the Intended Benefits of Communicating KAM in the Auditor's Report?

The auditor's report is the key deliverable addressing the output of the audit process for users of the audited financial statements. Users of the audited financial statements have expressed a need for additional information about matters of significance in the audit, which often will relate to areas in the financial statements that are subject to significant judgments by management and the auditor.

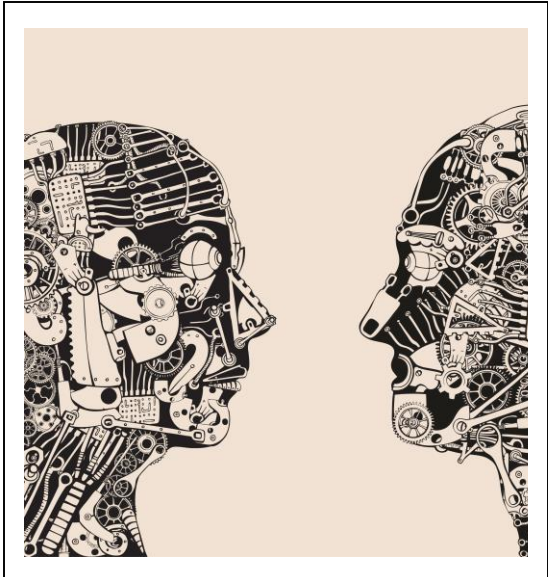
Communicating KAM does not change the auditor's underlying responsibilities in accordance with ISAs to conduct a thorough risk assessment, and design and perform procedures that are appropriate to respond to those risks, and to form an opinion based on the audit evidence obtained. Nor does it change the responsibilities of management and TCWG for the preparation and presentation of the financial statements, including appropriate disclosures in accordance with the applicable financial reporting framework. Rather, the inclusion of KAM in the auditor's report is intended to highlight, "through the eyes of the auditor", matters of most significance in the audit that was performed. Having KAM in auditor's reports may have positive benefits to 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.

Throughout the course of the IAASB's public consultation and outreach, the concept of KAM has received widespread support among investors, regulators and oversight authorities, accounting firms and national auditing standard setters. Including KAM in the auditor's report will reinvigorate the auditor's report for a

listed entity audit, making it more relevant and valuable to investors (in particular, institutional shareholders), and other users of the financial statements.

The IAASB believes that having KAM in auditor’s reports will:

- ❖ **Increase transparency** about the audit that was performed.
- ❖ **Focus investors and other users on areas in the financial statements that are subject to significant management judgment and significant auditor attention**, which may assist investors and other users in better understanding the entity and financial statements, and the outcome of the audit as reflected in the auditor’s opinion.



- ❖ **Provide users a basis to further engage with management and TCWG (e.g., audit committees)** about certain matters related to the entity, the audited financial statements, or the audit that was performed.
- ❖ **Enhance communications** between the auditor and Audit Committee about the most significant matters in the audit, and potentially result in **increased attention to disclosures** about those matters in the financial statements by management and the Audit Committee.
- ❖ **Renew auditor focus** on matters to be communicated, which could indirectly result in an increase in professional skepticism, among other contributors to audit quality.

Which Auditor’s Reports Will Include KAM?

The IAASB’s new and revised Auditor Reporting standards will be effective for audits of financial statements for periods ending on or after December 15, 2016 – that is, for December 31, 2016 reporting periods. The enhanced auditor’s reports would be available to users in early 2017.

As set out in ISA 700, [Forming an Opinion and Reporting on Financial Statements](#), the communication of KAM will be required for audits of financial statements of complete sets of general purpose financial statements of listed entities (“audits of financial statements of listed entities”).¹

Law or regulation may also require communication of KAM for audits of entities other than listed entities, for example, entities characterized in such law or regulation as “public interest entities”, or for public sector entities. KAM may also be communicated in the auditor’s report for entities other than listed entities, for example at the request of management or the Audit Committee, or at the discretion of the auditor.

How Will Auditors Determine KAM?

KAM should be specific to the entity and the audit that was performed in order to provide relevant information to users. Therefore, ISA 701 includes a **judgment-based decision-making framework** to help

¹ ISA 700, paragraph 31

auditors determine which matters are KAM.² This decision-making framework was developed to focus auditors on areas about which users have expressed the most interest. Application of the decision-making framework should therefore guide auditors to communicate KAM that are entity-specific, meaningful and relevant to users' needs.

As an initial step in determining KAM, ISA 701 requires the auditor to determine, from the **matters that were communicated with TCWG**, those matters that required **significant auditor attention**. The auditor is always explicitly required to consider:

- ❖ Areas of higher assessed risks of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).³
- ❖ Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- ❖ The effect on the audit of significant events or transactions that occurred during the year.

Once the auditor has determined the matters that required significant auditor attention, the auditor is then required to determine which of those **matters were of most significance in the audit** of the financial statements of the current period and therefore are the KAM.⁴ ISA 701 provides robust guidance to support the decision-making framework in determining the relative significance of a matter communicated with TCWG and whether such a matter is a KAM, noting the following considerations, among others, may be relevant:

- ❖ The nature and extent of communication with TCWG about the matter, because the auditor may have had more in-depth, frequent or robust interactions with TCWG on more difficult and complex matters.
- ❖ The importance of the matter to intended users' understanding of the financial statements as a whole, in particular, its materiality to the financial statements.
- ❖ The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate accounting policy compared to other entities within its industry.
- ❖ The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any.
- ❖ The nature and extent of audit effort needed to address the matter, including the extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any, and the nature of consultations outside the engagement team regarding the matter.

² See ISA 701, paragraphs 9–10 and A9–A30. ISA 260 (Revised), [Communication with Those Charged with Governance](#), and other ISAs set out requirements for auditors to communicate with TCWG about specific matters, including significant audit findings.

³ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. This standard, together with ISA 330, *The Auditor's Responses to Assessed Risks*, underpins the risk-based approach of an audit conducted in accordance with ISAs.

⁴ ISA 701, paragraphs 10 and A27–A30

- ❖ The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor’s opinion, in particular as the auditor’s judgments become more subjective.
- ❖ The severity of any control deficiencies identified relevant to the matter.

The auditor’s decision-making process in determining KAM is designed to select a smaller number of matters from the matters communicated with TCWG to be communicated in the auditor’s report. In addition, the application of a risk-based approach in an ISA audit is such that, while entities themselves may have similar sets of facts and circumstances, audits of similar entities may not be conducted in the same way. Therefore, KAM may differ depending on the approach taken by the auditor because certain entity-specific or audit-specific factors may influence the auditor’s judgment as to which matters were of most significance in the audit of the current period.

The IAASB believes the manner in which ISA 701 is drafted achieves an appropriate balance between prescription to promote consistency in which matters are determined and communicated as KAM, with the need to allow for auditor judgment to ensure that the KAM communicated in the auditor’s report are as entity-specific and relevant as possible – a point continuously stressed by investors as essential to the success of the project.

The number of KAM that will be communicated in the auditor’s report may be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstance of the audit engagement. It is envisaged that, for an audit of a listed entity, there will be at least one KAM.

How Much Detail Will Be Included in a KAM in the Auditor’s Report?

The requirement in ISA 701 relating to the description of a KAM is intended to result in a description that provides a succinct and balanced explanation to enable intended users to understand why the matter was one of most significance in the audit and how the

matter was addressed in the audit.⁵ The description of a KAM will also always refer to any related disclosures in the financial statements. However, the level of detail that is included in each description of a KAM is a matter of professional judgment, and may vary depending on the specific facts and circumstances of the particular engagement. The IAASB was of the view that this flexibility was important to enable auditors to be as entity-specific and audit-specific as possible in the description of a KAM, in order to mitigate concerns from investors and others that communication of KAM could quickly result in more standardized or “boilerplate” communications.

ISA 701⁶ explains that auditors may describe how a KAM was addressed in the audit by describing:

- ❖ Aspects of the auditor’s response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement;
- ❖ A brief overview of procedures performed;
- ❖ An indication of the outcome of the auditor’s procedures; or

⁵ ISA 701, paragraphs 13 and A34

⁶ ISA 701, paragraph A46

- ❖ Key observations with respect to the matter; or some combination of these elements.

In order for users to understand the significance of a KAM in the context of an audit of the financial statements as a whole, as well as the relationship between KAM and other elements of the auditor's report, including the auditor's opinion, auditors will need to be careful that the language in the description of a KAM limits the use of highly technical language and:

- ❖ Does not imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements.
- ❖ Relates the matter directly to the specific circumstances of the entity, while avoiding generic or standardized language.
- ❖ Takes into account how the matter is addressed in the related disclosure(s) in the financial statements, if any.
- ❖ Does not contain or imply discrete opinions on separate elements of the financial statements (a "piecemeal opinion").⁷

The description of a KAM should be entity-specific and avoid standardized or technical language. This helps to make the description understandable to intended users of the financial statements who may not necessarily have an in-depth understanding of auditing.

The auditor's communication of KAM in the auditor's report is not intended to be a substitute for the inclusion of appropriate and relevant financial statement disclosures, as information about the financial statements and the entity is primarily the responsibility of management. Accordingly, it is appropriate for the auditor to seek to avoid providing original information⁸ about the entity in the description of a KAM.

The KAM section of the auditor's report will include introductory language⁹ to explain that the auditor addressed the matters in the context of the audit of the financial statements as a whole, and in forming the opinion thereon, and does not provide a separate opinion on these matters.

⁷ ISA 701, paragraph A47

⁸ Paragraph A35 of ISA 701 describes original information as any information about the entity that has not otherwise been made publicly available by the entity (e.g., has not been included in the financial statements or other information available at the date of the auditor's report, or addressed in other oral or written communications by management or those charged with governance, such as a preliminary announcement of financial information or investor briefings).

⁹ ISA 701, paragraph 11

Next Steps

Efforts to adopt and effectively implement ISA 701 will represent a significant change in practice. Now that the final Auditor Reporting standards have been issued, national auditing standard setters will consider these changes in view of law and regulation in their respective jurisdictions. Accounting firms will commence the important work of developing implementation guidance, training and communications necessary to educate engagement teams that will communicate KAM in their auditor's reports.

To assist in this regard, a limited number of KAM examples are currently being developed to illustrate how the requirements of ISA 701 may be applied, although the IAASB recognizes the importance of the concept of KAM evolving over time to respond to investors' needs.

The IAASB will continue to monitor implementation activities through its ongoing outreach with key stakeholders, and intends to undertake a post-implementation review of the new and revised Auditor Reporting standards after a period of two years from the effective date.

Among other aims, this review will assist the IAASB in assessing whether the communication of KAM in accordance with ISA 701 has achieved its intended effect and is meeting users' needs.

For access to the new and revised Auditor Reporting standards, more information about the changes to the auditor's report, and other Auditor Reporting Toolkit materials, please visit the New Auditor's Report webpage at www.iaasb.org/auditor-reporting.