The Enhanced Auditor's Report – Post implementation review in South Africa

The new and revised auditor reporting standards became effective for audits of financial statements for periods ending on or after 15 December 2016. With more than two years of post-implementation experience, this SAICA publication provides an overview and analysis of the revised format auditor's reports of certain entities listed on the JSE Limited (JSE).

Transparent and high quality financial reporting are critical in creating and sustaining investor confidence in the South African economic markets. The auditor reporting standards were revised with the aim of enhancing the communicative value of the auditor's report by increasing transparency about audits performed. The new and revised requirements were also aimed at driving more robust discussions between the auditor, management and audit committees. Furthermore, it was pre-empted that the reporting of key audit matters (KAMs) would provide investors with a basis for discussion when engaging with companies. All of these activities were ultimately aimed at enhancing the confidence of users of financial statements in the external audit process.

About the research

SAICA analysed the auditors' reports of the top 40 South African companies (based on market capitalisation) listed on the JSE[1] for the first two years where KAMs were reported in the auditors' reports in South Africa, for those companies that were listed during that period (referred to in this article as the "Top 40 Companies"). For example: If a selected company has a December year-end, the analysis of the auditor's report issued on the December 2016 financial year has been included in the "Year 1" results, and the analysis of the auditor's report issued on the December 2017 financial year has been included in the "Year 2" results. For a selected company with a June year-end, the analysis of the auditor's report issued on the June 2017 financial year has been included in the "Year 1" results, and the analysis of the auditors' reports issued on the June 2018 financial year has been included in the "Year 2" results. The research was directed at the auditors' reports issued on the consolidated financial statements and did not include the auditors' reports issued on the separate financial statements.

The trends and type of information provided in the auditor's reports issued on the Top 40 Companies are reported herein.

Analysis by Audit Firm

The graph below depicts the number of the Top 40 Companies that were audited by the relevant audit firm or joint auditors.

[1] Top 100 JSE Listed Firms by Market Capitalization at 28 January 2019 on www.sashares.co.za

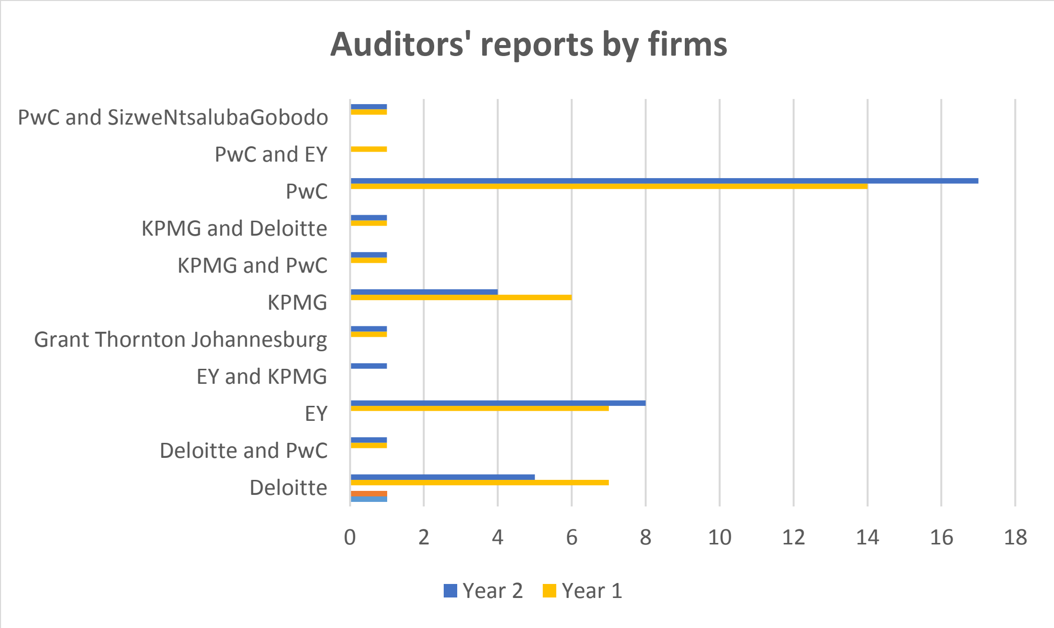

Figure 1: Auditors' Reports issued by firms or joint auditors

Key Audit Matters

Registered Auditors are required to communicate KAMs in auditor's reports issued on listed entities as well as when the auditor is required by law or regulation to communicate KAMs in the auditor's report. Communicating KAMs in the auditor's report issued on entities other than these is voluntary[2].

The communication of KAMs provide an opportunity for the auditor to share the matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. KAMs are selected from matters communicated with those charged with governance[3].

With regard to the content of the auditor's report, the auditor is required to describe each KAM, include a reference to the related disclosure(s) if any, in the financial statements, address why the item is a KAM and to clarify how the KAM has been addressed during the audit[4]. Although the ISAs do contain illustrative auditors' reports which indicate where the auditors are required to report KAMs[5], the ISAs are not prescriptive in terms of the specific details and description of KAMs. The auditor is required to apply professional judgement in formulating, describing and presenting the KAMs. This was done intentionally by the IAASB to avoid the establishment of boilerplate wording in the application of ISA 701, Communicating Audit Matters in the Independent Auditor's Report.[6] The description of KAMs in the revised auditor's report is intended to be specific to the entity and to provide useful and relevant information about the audit of an entity to the user of the auditor's report.

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[2] ISA 701*, Communicating Key Audit Matters in the Independent Auditor's Report, paragraph 5*

[3] ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report,* paragraph 8

[4] ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraphs 11 and 13

[5] ISA 700, *Forming an Opinion and Reporting on Financial Statements,* Appendix

[6] ISA 700, *Forming an Opinion and Reporting on Financial Statements,* Appendix

Most frequently reported KAM topics

The reporting of KAMs is not indicative of the quality of governance in an entity. It is merely the auditor presenting some of the matters that have been communicated with those charged with governance of an entity.

The most commonly reported KAMs by topic are illustrated in the diagram below:

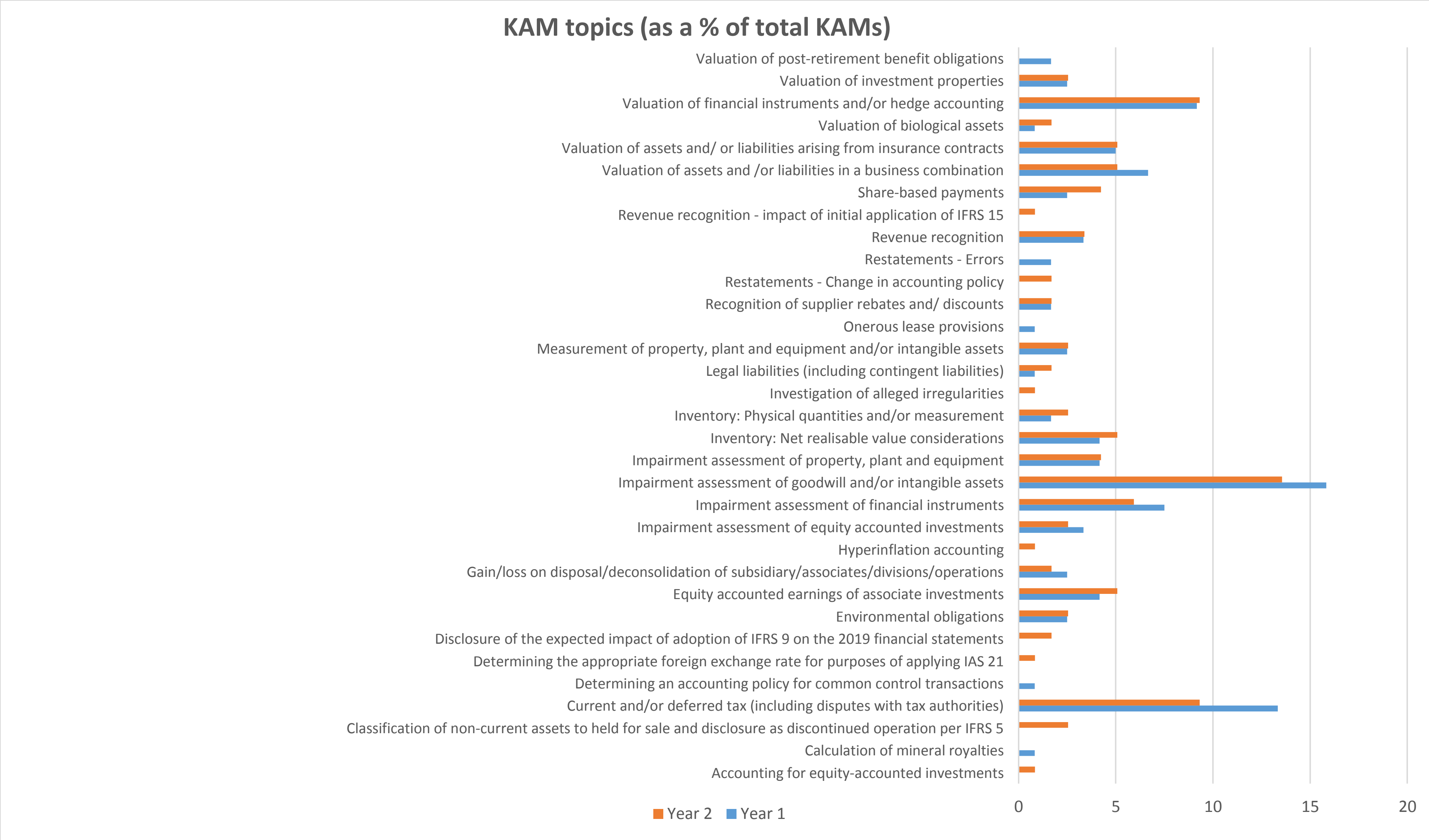

Figure 2: KAMs reported in Year 1 and Year 2

KAM topics in certain other jurisdictions

Below are graphs that depict the most frequently reported KAMs in the United Kingdom, New Zealand and Malaysia, respectively, in comparison to those reported in South Africa.

United Kingdom

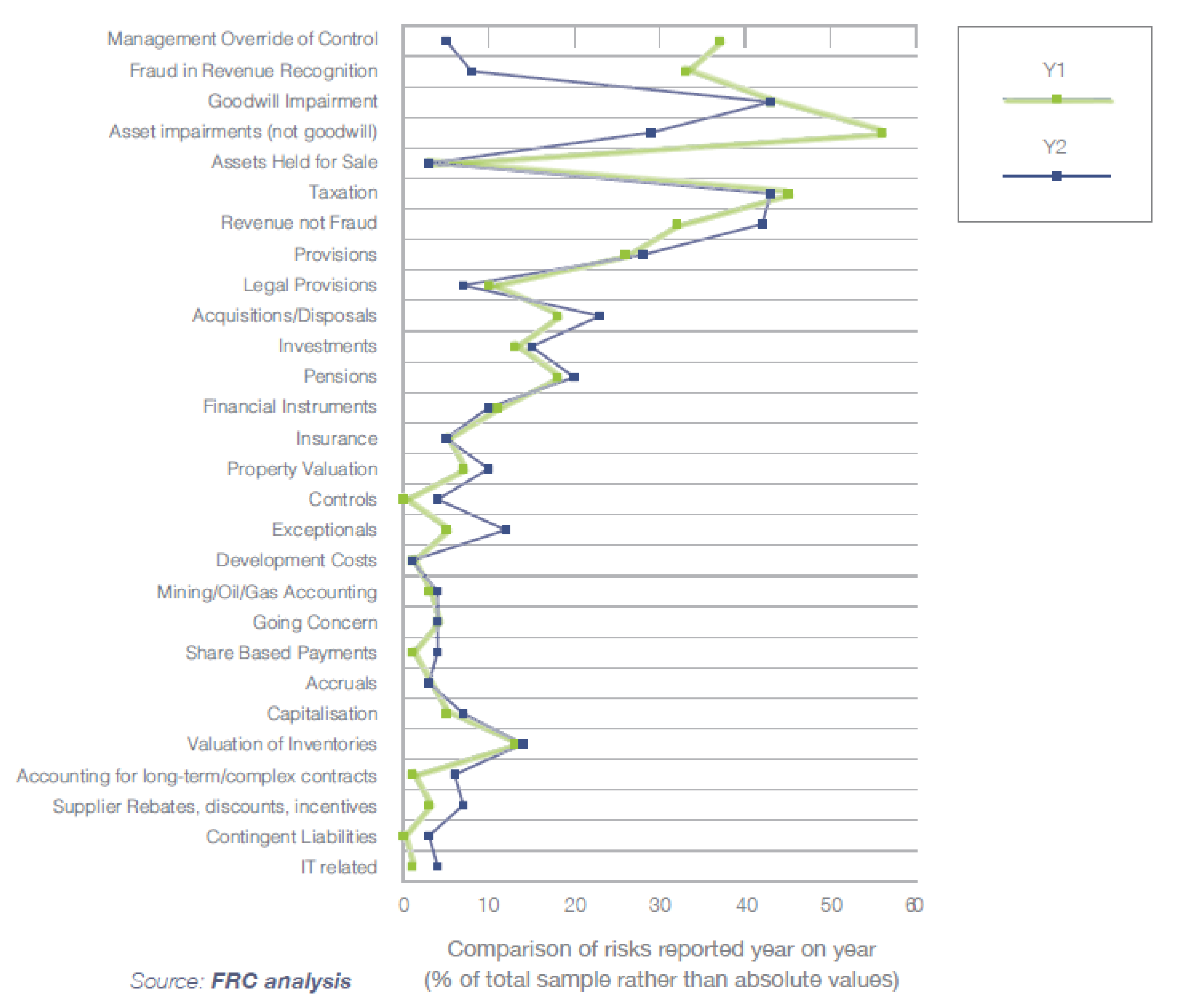

Figure 3: Extract from the Financial Reporting Council (FRC): Extended auditor's reports: A further review of experience (January 2016) page 16

New Zealand

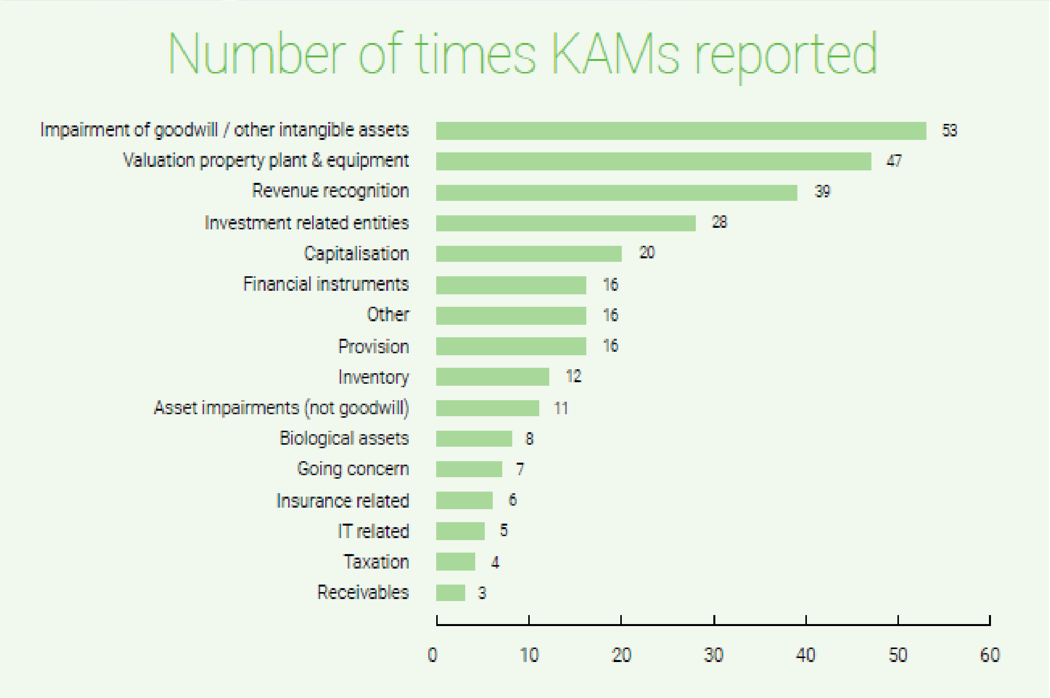

Figure 4: Extract from the External Reporting Board, Key Audit Matters, A stock take of the first year in New Zealand, November 2017, page 9

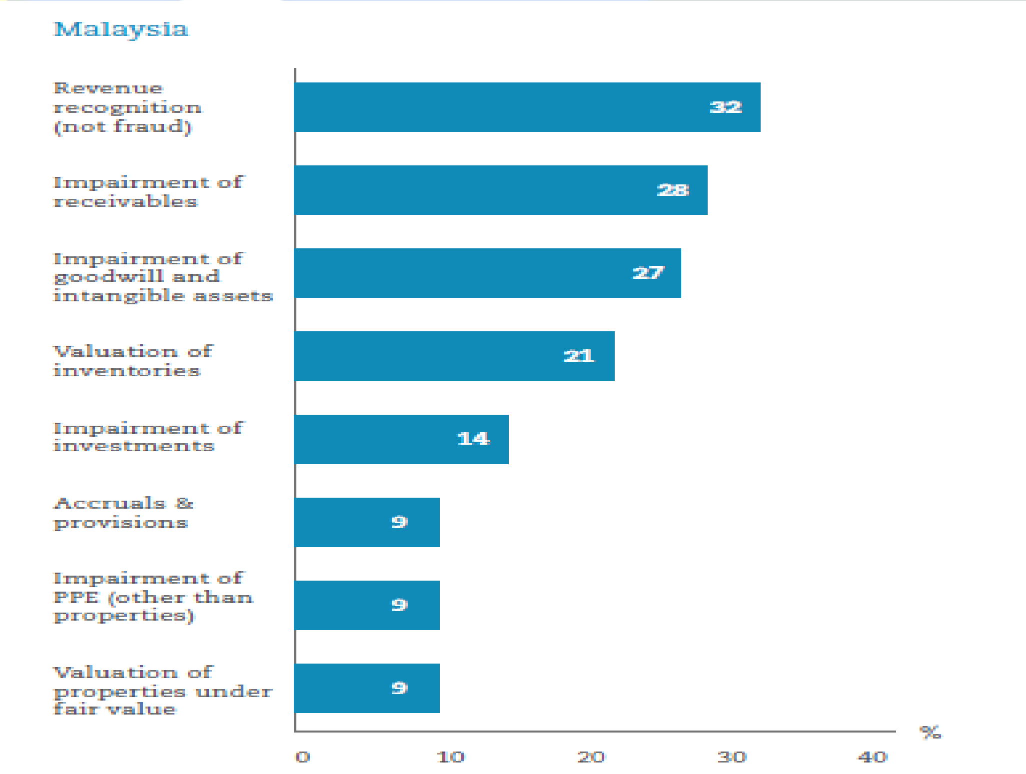

Figure 5: Extract from the ACCA Global, Enhanced Auditor's report: A review of first year implementation experience in Malaysia, January 2018, page 18

The nature of the KAMs being identified in the jurisdictions above relate largely to revenue recognition, impairment of assets and valuations. There are similarities to the KAMs reported in South Africa with the exception of revenue which does not feature highly on the South African KAMs for the period analysed.

Number of KAMs reported

The table depicts the number of KAMs reported in the auditors' reports issued on the Top 40 Companies.

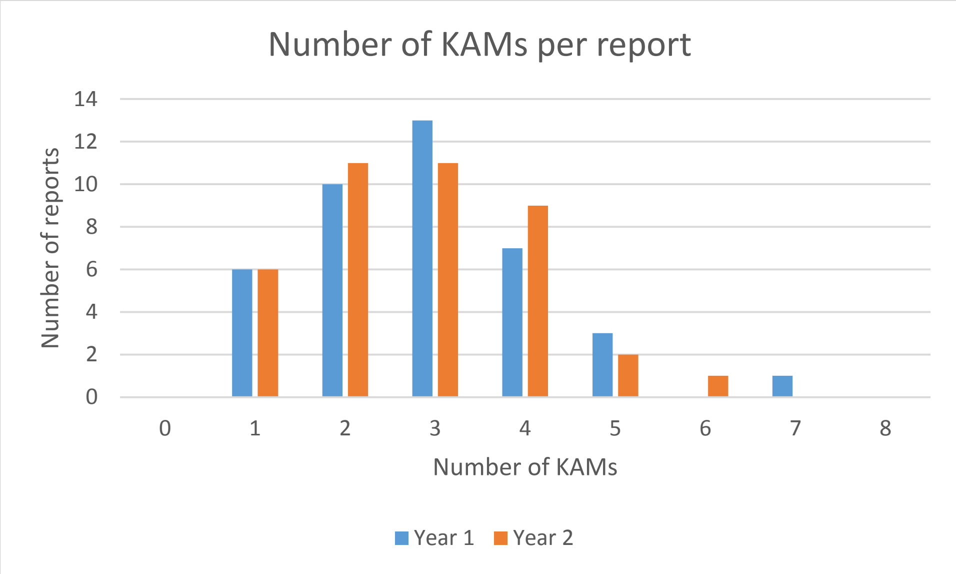

Figure 6: Frequency of number of KAMs per auditor's reports

Analysis of KAMs reported by audit firms or joint auditors

The table below shows the average number of KAMs reported by each of the audit firms or joint auditors in Year 1 and Year 2 regarding the Top 40 Companies.

Audit firm	**Average KAMs per auditor's reports Year 1**	**Average KAMs per auditor's reports Year 2**
Deloitte	3.14	2.20
EY	2.14	2.37
Grant Thornton	3.00	3.00
KPMG	2.33	2.50
PwC	2.71	2.59
Deloitte and PwC	3.00	4.00
EY and KPMG	-	5.00
KPMG and PwC	7.00	6.00
PwC and EY	4.00	-
PwC and SizweNtsaluba Gobodo	3.00	4.00
KPMG and Deloitte	3.00	3.00

Table 1: Number of KAMs reported by audit firms or joint auditors

From this analysis, more KAMs were reported when joint audits were performed. It is however important to consider these statistics in context of the nature of the entities that these audits relate to; the majority of the joint audits included in the analysis related to the audit of a large bank. Determining which, and how many, of those matters that required significant auditor attention were of most significance in the audit of the financial statements of the current period is a matter of professional judgement. The number of KAMs to be included 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 circumstances of the audit engagement[7].

Change in auditors – effect on KAMs reported

In most of the instances where there were changes in auditors from Year 1 to Year 2, there was an increase in the number of KAMs reported as depicted in the table below.

Auditee	**Year 1 auditor or joint auditors**	**Year 2 auditor or joint auditors**	**Year 1 number of KAMs reported**	**Year 2 number of KAMs reported**	**Change**	**New KAM topic (where applicable)**
ABSA Group Limited	PWC and EY	EY and KPMG	4	5	+1	Uncertain tax positions
Pepkor Holdings Limited	Deloitte	PWC	4	4	-	Ongoing Investigation of alleged irregularities; and Inventory: Provision for shrinkage, obsolescence and mark down of inventories[8]
Mondi Limited	Deloitte	PWC	3	4	+1	Valuation of forestry assets
The Foschini Group Limited	KPMG	Deloitte	2	2	-	KAM topics remained the same
AVI Limited	KPMG	EY	1	2	+1	Broad-based black economic empowerment ("BBBEE") transaction relating to I&J and Main Street

[7] ISA 701, Communication of Key audit matters paragraph A30

[8] In 2017, KAMs relating to (a) Valuation of assets and/or liabilities in a business combination and (b) Determining an accounting policy for common control transactions were reported. These were not included in the 2018 audit report.

Spar Group Limited	Deloitte	PWC	2	3	+1	Classification of supplier rebates; and Presentation of the income and expenses of the SPAR Guild and Build It (Group)[9]

Table 2: KAMs reported where there has been a change in auditors

For some audits, the nature of the KAMs reported by the new auditor were substantially the same, for example the audit of Foschini Group Limited. In other instances, there were either additions to the KAMs reported by the new auditor or the nature of the KAMs reported varied from year to year. For example, in the audit of Pepkor Holdings Limited, there was no change in the number of KAMs reported from Year 1 to Year 2 but the new auditor reported different KAMs to those previously reported.

Voluntary reporting

Indication of the outcome of the auditor's procedures

In Year 2, 65% (Year 1: 62.5%) of the auditors' reports that were analysed provided voluntary disclosure of the outcome of some of the audit procedures performed regarding the identified KAMs.

Although providing such information is not required by the ISAs[10], it enhances the communicative value of the auditor's report by answering the "so what?" question that users may have in mind. This may contribute to closing the audit expectation gap as it may give users of the financial statements a better understanding of the audit process.

The auditor forms an opinion on the financial statements as a whole. The ISAs caution that, where the auditor does provide an indication of the outcome of the auditor's response in the description of the KAM in the auditor's report, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual KAM or that in any way may call into question the auditor's opinion on the financial statements as a whole[11].

[9] A KAM relating to the Impairment assessment of goodwill and/or intangible assets was reported in the 2017 auditor's report. This was not reported as a KAM by the new auditors in 2018.

[10] ISA 701, *Communicating key audit matters in the Independent auditor's report,* paragraph A46

[11] ISA 701, *Communicating key audit matters in the Independent auditor's report*, paragraph A51

Examples from the auditor's reports that we analysed where an indication of the outcome of the auditor's procedures was described:

"The discount rates of management were considered to be within an acceptable range of our independent calculations."[12]

"Our testing found the methodology for the identification and valuation of specific impairments and the related judgements applied, to be reasonable and in accordance with the requirements of IFRS."[13]

"Whilst certain of the assumptions included in the impairment model includes a degree of conservatism, we consider this to be appropriate as the model is a long-term model and there is inherent volatility in various of the "uncontrollable assumptions" such as iron ore prices, freight rates, exchange rates and lump premiums. In terms of our assessment of the qualitative factors and the results arising from the impairment model, we consider it appropriate that the impairment charge was reversed at the year-end."[14]

Group scoping and materiality

The ISAs explain that the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements and that this is achieved by the auditor expressing an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework[15]. Materiality is therefore an important concept in performing an audit. This is applied throughout the audit, as follows:

- planning the audit
- executing the audit procedures
- evaluating the effect of identified misstatements on the financial statements
- forming the audit opinion

The ISAs neither require the auditor to disclose the materiality figure that has been applied during the audit in the auditor's report nor prohibit the auditor from doing so. While some jurisdictions such as the United Kingdom have made it a mandatory requirement for auditors to disclose information about the materiality figure applied in the auditor's report issued on certain entities, doing so is voluntary in South Africa.

In both Year 1 and Year 2, PwC was the only firm that disclosed the materiality figure in all of the auditors' reports included in our research population, except in those instances where they were part to a joint audit. The PwC auditors' reports included details of the overall group materiality figure, the benchmark that was used in determining the materiality and the rationale for selecting the benchmark.

The ISAs also do not require auditors to provide a bespoke overview of the scope of the audit in the auditor's report, as is required, for example in the United Kingdom for certain entities. PwC was the only firm that included a description of the audit scope relating to consolidated financial statements in

[12] Auditor's report of MTN Group Limited, 31 December 2016, KAM: *Impairment assessment of goodwill arising from business combinations*
[13] Auditor's report on Standard Bank Group Limited, 31 December 2017, KAM: *Credit impairment losses on loans and advances*
[14] Auditor's report on Kumba Iron Ore Limited, 31 December 2017, KAM: *Impairment considerations for Sishen mine cash generating unit (CGU) and idle assets*
[15] ISA 200, *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing*, paragraph 11(a)

all of the auditors' reports that form part of the research population, except when they were part of a joint audit.

Overview of the audit and diagrams

In both Year 1 and Year 2, PwC was the only firm that included an "Overview" section in the auditor's report which summarised the overall group materiality, group audit scope and listed the KAMs. This was done in all the PwC auditors' reports included in our research population, except in those instances where they were part of joint auditor engagements. The majority of the overview sections also contained a diagram, depicting materiality, group scoping and key audit matters. The inclusion of this information in the auditor's report is not required by the ISAs.

Going concern

Going concern continues to be a pertinent factor for both management to assess in the preparation of the financial statements and for the auditor to consider during the audit. In many cases, there is an expectation by stakeholders for management and the auditor to pay close attention to going concern matters. The revised auditor reporting standards require the following regarding going concern[16]:

- A description of the responsibilities of management and those of the auditors relating to going concern be included in the auditor's report[17];
- When the use of the going concern basis of accounting is inappropriate in the auditor's judgement, the auditor shall express an adverse opinion[18];
- When the use of the going concern basis of accounting is appropriate but a material uncertainty exists, which has been adequately disclosed in the financial statements, a separate section called "Material Uncertainty related to Going concern"[19] must be included in the auditor's report
- When adequate disclosure of a material uncertainty is not made in the financial statements, the auditor shall express a qualified or adverse opinion, as appropriate[20]

None of the auditor's reports analysed contained sections on material uncertainty related to going concern.

Conclusion

The extent of communication by the auditor has improved in the revised auditor's report, in that the reporting is more transparent and tailored to the unique circumstances of the various engagements. Some of the auditor's reports have been made more visually appealing through the inclusion of diagrams and tables. This represents and has achieved a clear breakaway from the generic reports that existed in the past. While KAMs improve transparency and play an important role in educating the users of financial statements about the audit process, they are not necessarily an indication of the maturity and quality of a company's financial reporting process and should not be construed as such

[16] Refer to South African Auditing Practice Statement (SAAPS) 3, *Illustrative Reports,* Appendix 1 for the Going concern decision tree
[17] ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements,* paragraphs 33 and 37
[18] ISA 570 (Revised), *Going Concern*, paragraph 21
[19] ISA 570 (Revised), *Going Concern,* paragraph 22
[20] ISA 570 (Revised), *Going Concern*, paragraph 23

by the users of financial statements. They do, however, provide a basis to drive more robust conversations between all affected parties.

SAICA acknowledges the hard work that audit firms have put in to ensure compliance with the new auditor reporting standards. The research indicates positive developments and we look forward to further enhancements from the audit firms as the evolution of the auditor’s report unfolds.

SAICA will continue to monitor developments in this area, to update members and educate all stakeholders in order to promote a better understanding of the audit process.