

Costs and Benefits of Key Audit Matter Reporting for Smaller Public Entities: The Australian Experience

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Executive Summary

The purpose of this analysis is to gather evidence regarding the costs and benefits of key audit matter (KAM) reporting for smaller public entities. We examined 362 Australian listed entities with year ends between December 15, 2016 and December 15, 2017 and with market capitalization of less than AUD\$10 million. We found no significant impact on audit fees with the introduction of KAM reporting for the entities examined. We also found that KAM reporting provided an effective 'signal' to readers of the key audit issues that arose. However, in certain situations, we found that KAM reporting did not provide 'transparency' about those key audit issues.

Based on the Australian experience, we conclude that there is value to KAM reporting by smaller listed entities and that the value could be increased if KAM reporting were more transparent.

Introduction

The AASB announced in November 2016 that it intended to conduct research to help it determine whether KAM reporting should be required for smaller listed entities.¹ The purpose of our research is to gather evidence to assist the AASB to better understand the costs and benefits of enhanced auditor reporting with a focus on smaller listed entities and to identify potential implementation challenges.

Scope

Our review focused on audit reports issued by auditors of Australian listed entities with year ends between December 15, 2016 and December 15, 2017. We focused on Australian listed entities because there are a large number of smaller listed entities in Australia and many of these are in the metals and mining industries and in technology. This market profile is similar to that in Canada. We focused on the period from December 15, 2016 to December 15, 2017 as this was the first year that KAM reporting was required for these entities.

For purposes of our analysis, we focused on listed entities with a market capitalization of less than AUD\$10 million. At June 30, 2017, the Australian dollar (AUD\$) was roughly on par with the Canadian dollar. We identified 362 entities that met these criteria.

Number of KAMs Reported

The following table summarizes the number of KAMs reported:

Average number of KAMs reported	1.5
Percentage of reports with no KAMs	8.5%
Percentage of reports with 1 KAM	47.2%
Percentage of reports with 2 KAMs	30.7%
Percentage of reports with 3 KAMs	11.6%
Percentage of reports with 4 KAMs	1.7%
Percentage of reports with 5 KAMs	0.3%

There was no significant difference in the number of KAMs reported in different industries.

Costs of Implementing KAM Reporting

We analyzed the costs of implementing KAM reporting by looking at the change in audit fees from 2016 when KAM reporting was not required to 2017 when KAM reporting was required.

The following table shows the changes in audit fees in the year KAM reporting was introduced:

¹ Auditing and Assurance Standards Board, 2016. *Message from the Chair: Moving Forward on New Auditor Reporting and Other Standards*, November 2016.

Average change in audit fee	-2.9%
Median change in audit fee	0.0%
Percentage of firms with a decrease in audit fees	48.5%
Percentage of firms with no change in audit fees	5.2%
Percentage of firms with an increase in audit fees	46.3%

Our analysis found that there was no significant change in audit fees for smaller Australian listed entities associated with the introduction of KAM reporting. The Technical Director of the Australian Auditing and Assurance Standards Board indicated to us that the Australian audit market was quite competitive at the time and that this may have impacted audit fees. Our analysis of the cost of implementing KAM reporting was based only on audit fees. Additional costs may have been incurred by both the listed entities and by their auditors in implementing the KAM reporting requirements but we have no data on what these costs might have been.

Benefits of Implementing KAM Reporting

We analyzed the benefits of implementing KAM reporting by looking at the communicative value of the KAM reporting. We did this by considering two aspects of the KAM reporting: the ‘signaling’ of the most significant matters in the audit, and the ‘transparency’ of the reporting about KAMs.

Signaling

Signaling can have value by directing users’ attention to certain areas of the audit and related financial statements. Signaling can be done even with relatively standardized KAMs that provide little or no information specific to the entity². The following table shows the three most frequently reported types of KAMs for the five largest industry sectors.

	Mining & Metals	Oil & Gas	Technology & Medical	Utilities/ Transport/ Industrial	Services/ Food/ Retail
Exploration and evaluation assets	①	①			
Goodwill and intangibles			①	①	①
Other noncurrent assets	③	②		③	
Acquisitions and disposals	②		②		③
Liabilities and provisions	③	③		②	
Revenue recognition			②	③	②
Going concern					③

² Brian L. Connelly, S. Trevis Certo, R. Duane Ireland, and Christopher R. Reutzel, “Signaling Theory: A Review and Assessment”, *Journal of Management* 37, no. 1: 39-67.

We find that audit reports for smaller listed entities deliver this element of communicative value. In each of the industry sectors, the areas of the audit that are most frequently identified as KAMs are those that we would expect based on the nature of the industry.

The KAMs typically provide a description of key issues in accounting for the KAM and a description of some of the audit procedures performed. The following is an example of a KAM for a property development company:

“Carrying value assessment for (Undeveloped) Property Assets Refer to Note 8 – carrying value of \$2.3 million

Assessing the carrying amount of the Company’s interests in the (undeveloped) properties located at 3 Oak Street, Cannington and 19-21 Tate Street, Bentley, Western Australia was a key audit matter. Factors giving rise to this conclusion included the size of the balance and the judgment required in the assessment given the medium to long term nature of the asset, particularly in relation to:

- whether development of these properties will ultimately proceed. These vacant land were purchased several years ago and development applications for multiple dwellings (apartments) on these lots were granted by the respective town councils. However, development plans have been placed on hold due to the inability to secure project financing;
- the current uncertain outlook of the Perth property market especially the multiple- dwelling property segment which directly influences the funding appetite of potential lenders/investors.

We performed procedures over the assessment of the carrying values of the (undeveloped) properties, including with respect to whether the developments will proceed, by updating our understanding of:

- The progress and status of any ongoing and anticipated negotiations taking place between the Company’s directors and potential funders/investors to finance the development and likely timing.
- The state of the Perth apartment property market and its future outlook based on available market data/commentary and information sourced from the public domain/industry publications.

Having updated our understanding of the above points, we considered whether there were any indicators the properties were impaired. This was also facilitated in part by an independent market appraisal on the properties obtained by the Directors during the year.

In addition to verifying that the impairment expense recognised in the financial statements was considered appropriate; we also undertook the following:

- Evaluated the independent appraiser’s competence, capabilities and objectivity;
- Assessed the appropriateness of the appraised values by comparing against indicative market values of similar properties (by location and size) being advertised for sale from sources such as www.realestate.com.au

- Reviewed the relevant disclosures contained in the financial statements³

These descriptions can help to educate users regarding the key judgements involved with the KAM and the nature of the procedures performed by the auditor.

Transparency

“The purpose of communicating key audit matters is to enhance the communicative value of the auditor’s report by providing greater transparency about the audit that was performed.”⁴

Communicative value can be enhanced if transparent information is provided about the KAM. The standards encourage transparency in describing why the matter was considered significant by encouraging the auditor “to highlight aspects specific to the entity (e.g., circumstances that affected the underlying judgments made in the financial statements of the current period)”⁵ and to provide “an indication of the outcome of the auditor's procedures; or key observations with respect to the matter”⁶.

Our finding is that, in certain situations, KAM reporting did not provide transparency about the key audit matters. The following example related to the exploration and evaluation (E&E) assets of a gold mining entity illustrates this lack of transparency. The KAM reported for this entity is as follows:

“Carrying value of Exploration and Evaluation Asset

Exploration and evaluation assets of \$8,953,712 form a significant proportion of the Group’s assets as shown in note 13.

The recovery of the carrying value of the exploration and evaluation assets are subject to successful exploration, exploitation or sale in the future and as such is subject to management judgement in accordance with AASB 6 - Exploration for and Evaluation of Mineral Resources. Management have relied on the valuations prepared by third party expert valuers to support the carrying value of exploration assets at 30 June 2017.

The Group’s exploration and evaluation assets are also exposed to market, economic, political and seasonal influences which may affect the value.

Exploration and evaluation expenditure is recorded in accordance with the accounting policy detailed in note 1 of the notes to the financial statements.

Our procedures in relation to the carrying value of exploration and evaluation included, amongst others:

- Assessing the competence, capabilities, objectivity and independence of the management experts engaged to value the assets, and the methodology they adopted;

³ Annual Report for the financial year ended 30 June 2017. Ultima United Limited (2017).

⁴ International Standard on Auditing 701 Communicating Key Audit Matters in the Independent Auditor’s Report paragraph 2.

⁵ International Standard on Auditing 701 Communicating Key Audit Matters in the Independent Auditor’s Report paragraph A45.

⁶ International Standard on Auditing 701 Communicating Key Audit Matters in the Independent Auditor’s Report paragraph A46.

- Analysing the financial and operating commitments of the licenses to see whether sufficient expenditure has been included in the cash flow forecast to ensure expenditure conditions are met;
- Assessing the Group's rights to tenure over the relevant exploration areas by obtaining the license agreements and also considering whether the Group maintains the tenements in good standing;
- Assessing the ability of the Group to finance any planned future exploration and evaluation activity; and
- Ascertaining whether management has any plans to abandon the held tenements.”⁷

Additional information found in the Annual Report for this entity indicates that:

- Some mining properties are in New Guinea. Some of the entity's licenses in New Guinea were not renewed by the government.
- An impairment of AUD\$15 million was recognized during year “as a result of not meeting the requirements of AASB 6, whereby substantive expenditure on further exploration for and evaluation of mineral resources in the specific area is neither budgeted nor planned.”
- Impairment reduced E&E assets from AUD\$23 million to AUD\$9 million.
- Total assets of the company at June 30 are AUD\$10 million.

We find that this KAM does not provide good transparency about the audit that was performed. A user reading the KAM may not even be aware that a significant impairment had occurred.

In order to gather more evidence about the transparency of KAM reporting, we considered all gold mining entities on the Australian exchange that reported significant impairments during the year. Seven were identified from our sample of entities with market capitalizations of less than AUD\$10 million. We found that none of these provided good transparency related to the impairment issue. A further fifteen entities were identified that had market capitalizations above AUD\$10 million. We found that the reported KAMs for nine of these did provide good transparency related to the issue and six did not provide good transparency.

The following example illustrates what we consider an example of good transparency in a KAM related to impairment for a gold mining company:

“Impairment assessment of the Karouni CGU

The Group's financial report includes significant non-current assets at 30 June 2017 which consisted of Mine Property and Property, Plant and Equipment relating to the Group's Karouni gold mine and associated infrastructure in Guyana.

Due to the net assets of the Group exceeding its market capitalisation and operational performance issues, the Group identified indicators of impairment in its Karouni Cash Generating Unit (CGU) during the year.

As a result, the Group tested the Karouni CGU for impairment. Impairment charges of \$88.4 million were recognised in the financial report against Mine Property and \$20.0 million against Property, Plant and Equipment as a result of the Group's impairment assessment.

⁷ Annual Report for the year ended 30 June 2017. Crater Gold Mining Limited (2017).

The Group's impairment assessment was performed on a 'fair value less costs of disposal' basis to determine the recoverable amount of the Karouni CGU.

This assessment involved significant judgements made in relation to key assumptions. The most significant areas of judgments relate to:

- forecast of short and long term gold prices
- reserve and resource estimates and production and processing volumes
- operating costs, capital expenditure, foreign exchange rates and inflation rates
- timing of project development for projects with reserves or resources outside of the current mine plan
- discount rates.

Given the level of judgement involved, the magnitude of the Karouni CGU assets and the impairment charge recognised in the Group's financial report, we determined that this was a key audit matter.

How our audit addressed the key audit matter

We performed the following audit procedures, amongst others:

- assessed whether the composition of the Karouni CGU was consistent with our knowledge of the Group's operations.
- evaluated the Group's assessment that there were indicators of asset impairment at 30 June 2017.
- assessed whether the Karouni CGU appropriately included all directly attributable assets, liabilities and cash flows.
- considered if the discounted cash flow model used to estimate the recoverable amount of the Karouni CGU on a 'fair value less cost of disposal' basis (the impairment model) was consistent with Australian Accounting Standards.
- tested that the impairment model included an appropriate estimated transaction cost associated with selling the Karouni CGU.
- compared the forecast cash flows used in the impairment model to the most recent budgets and business plans approved by the Board.
- considered whether the forecast cash flows in the impairment model were reasonable and based on supportable assumptions, by:
 - comparing short and long term gold pricing data used in the impairment model to independent industry forecasts
 - comparing the forecast gold production over the life of mine to the Group's most recent reserves and resources statement
 - comparing the forecast cash flows to actual cash flows for previous years to assess the historical accuracy of the Group's forecasting
 - comparing foreign exchange rate and inflation rate assumptions in the impairment model to independent economic forecasts, and
 - assessing the Group's discount rate calculations in the impairment model, including having regard to the inputs utilised in the Group's weighted average cost of capital, assisted by PwC valuation experts
- performed sensitivity analysis on the key assumptions used in the impairment model.
- performed tests of the mathematical accuracy of the impairment model calculations and agreed the impairment charge calculated in the model to the impairment expense recognised in the consolidated statement of profit or loss and other comprehensive income.

- evaluated the adequacy of the disclosures made in note 14, including those regarding the key assumptions and sensitivities to changes in such assumptions, in light of the requirements of Australian Accounting Standards.”⁸

Based on the analysis performed, we find that, in certain situations, KAM reporting does not appear to meet the objective of “providing greater transparency about the audit that was performed” (IAS 701 paragraph 2). The KAMs sometimes read as ‘business as usual’ when, in fact, significant events have occurred. While we noted a lack of transparency in the KAM reporting for all sizes of entities we examined, this was particularly the case for the smaller entities.

Conclusions

Our analysis of audit reports for Australian listed entities with market capitalization of less than AUD\$10 million leads us to the following conclusions:

- We noted no significant impact on audit fees in the year when KAM reporting was introduced.
- We found that KAM reporting did provide an effective ‘signal’ to readers of the key audit issues that arose.
- We found that, in certain situations, KAM reporting did not provide ‘transparency’ about those key audit issues.

Therefore, based on the Australian experience, we conclude that there is value to KAM reporting by smaller listed entities and that the value could be increased if KAM reporting were more transparent.

Our finding that KAM reporting did not provide ‘transparency’ about key audit issues in certain situations suggests some standard setting concerns. While the audit reports appear to meet the specific requirements of IAS 701, they nonetheless do not appear to meet the objective of the standard. This suggests a need for guidance that reinforces the objective of the standard, for a well-designed implementation plan, and, perhaps, changes to strengthen the specific requirements in the standard.

⁸ *Annual Report*. Troy Resources Limited (2017).

Other Observations

Diversity in Going Concern (GC) Reporting

In looking at the audit reports for these smaller listed entities, we noticed a diversity in reporting approaches related to going concern uncertainties. The following table shows the number of reports with each of the different approaches to going concern reporting that we observed:

Disclaimer of opinion and no KAMs	5
Disclaimer of opinion and an asset impairment related KAM	1
Emphasis of matter paragraph and no GC related KAM	175
Emphasis of matter paragraph and a GC related KAM	13
No emphasis of matter paragraph and a GC related KAM	22

This diversity of reporting practices may reflect differing circumstances in the various audits. It could also result from confusion among auditors about how to handle going concern issues in the new audit report.

While we have not conducted a detailed review of the going concern reporting issue, we question whether such diversity of reporting will be confusing to readers of the reports.