

Audit & Assurance Alert

CANADIAN AUDITING STANDARDS (CAS)

DECEMBER 2018

CAS 701—Key Audit Matters

Originally published in May 2017 and has been updated in December 2018 to address the change in scope of when key audit matters are to be communicated.

This *Audit & Assurance Alert* is being issued to raise awareness about the requirements in CAS 701, which is one standard in the suite of new and revised auditor reporting standards. In CAS 701, the objective of the auditor is to determine key audit matters and, having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report. The suite of new and revised auditor reporting standards is effective for audits of financial statements for periods ending on or after December 15, 2018.

This *Alert* highlights for auditors, certain requirements and application material in CAS 701 and provides considerations for auditors in complying with the requirements. This *Alert* does not address all aspects of CAS 701 and should be read in conjunction with CPA Canada's *Audit & Assurance Alert—New and Revised Auditor Reporting Standards*.

When Are Key Audit Matters Communicated?

Canadian Auditing Standard (CAS) 701, *Communicating Key Audit Matters in the Independent Auditor's Report* applies to audits of complete sets of general purpose financial statements when:

- the auditor decides to communicate key audit matters in the auditor's report
- the auditor is required by law or regulation to communicate key audit matters in the auditor's report.

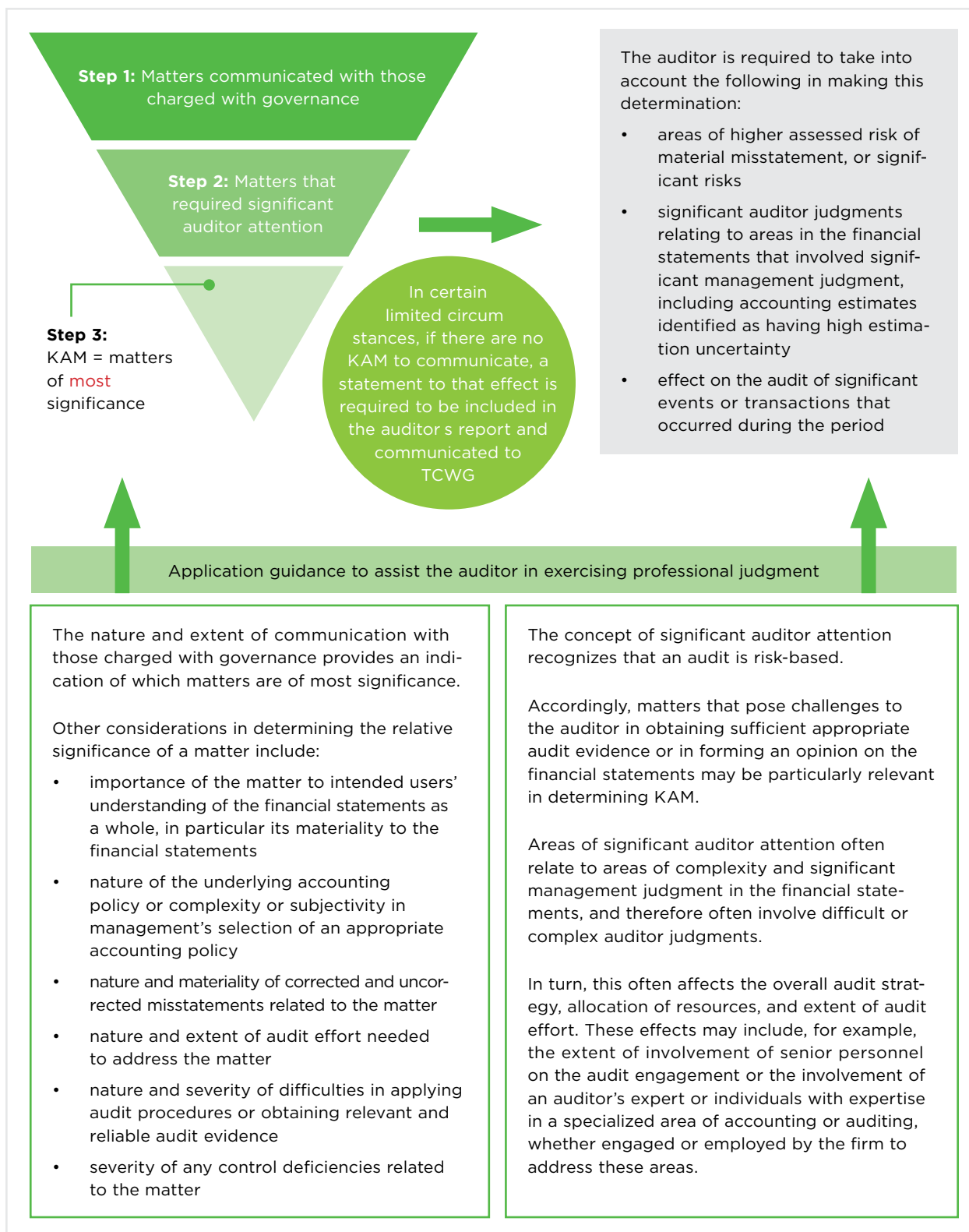
For periods ending on or after December 15, 2020, key audit matters are to be communicated for audits of complete sets of general purpose financial statements of entities listed on the Toronto Stock Exchange, other than entities required to comply with National Instrument 81-106, Investment Fund Continuous Disclosure.

What Are Key Audit Matters?

Key Audit Matters ("KAM") are those matters that, in the auditor's professional judgment, were of most significance in the audit of the entity's financial statements of the current period. KAM are selected from matters communicated with those charged with governance (TCWG) and placed in a separate section of the auditor's report. The auditor's determination of KAM is limited to those matters of most significance in the audit of the financial statements of the current period, even when the auditor's opinion refers to each period for which financial statements are presented. KAM are expected to be entity-specific and specific to the audit that was performed.

Refer to [Appendix A](#) for FAQs regarding KAM.

How Are Key Audit Matters Determined?



How Are KAM Communicated and Described?

When the auditor communicates KAM the auditor is required to describe each key audit matter, using an appropriate subheading, in a separate section of the auditor’s report under the heading “Key Audit Matters.” The introductory language in this section of the auditor’s report shall state that:

- Key audit matters 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.
- These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor’s opinion thereon; the auditor does not provide a separate opinion on these matters.

The auditor is required to describe KAM in the auditor’s report as follows:

Issue (i.e., the KAM)	Audit Response	Financial Statement Note Disclosure
why the matter was considered to be one of the most significant in the audit and therefore determined to be a KAM	how the matter was addressed in the audit	reference to the related financial statement note disclosure(s), if any

The description of KAM is intended to provide a succinct and balanced explanation of the matter and is most useful when it relates to the specific circumstances of the entity. CAS 701 provides some flexibility to enable auditors to include more entity-specific information in the auditor’s report. However, KAM are not a substitute for expressing a modified opinion and should not contain or imply discrete opinions on separate elements of the financial statements.

Documentation

The auditor is required to document the following relating to KAM:

- matters that required significant auditor attention during the audit (see step 2 of the diagram)
- rationale for the auditor’s determination as to whether or not each of those matters (in step 2 of the diagram) were KAM (under step 3 of the diagram)
- in the certain limited instances when there are no KAM communicated in the auditor’s report, the rationale for the auditor’s determination that there are no KAM to report

Illustrative Example of a Key Audit Matter

The following is an example of how a key audit matter could be communicated and described in the auditor's report:

Goodwill

Under IFRSs, the Company is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of \$XX as of December 31, 20X1 is material to the financial statements and management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe significant assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area] and cause a high degree of estimation uncertainty.

Our audit procedures included, among others, using the work of a valuation expert to assist us in evaluating the methodologies, assumptions and data used by the Company, in particular those assumptions relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Company's disclosures about those significant assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill and cause the high degree of estimation uncertainty.

The Company's disclosures about goodwill are included in Note X, which specifically explains that small changes in the significant assumptions used could give rise to an impairment of the goodwill balance in the future.

describes the issue

describes the audit response

refers to the financial statement note disclosure

Timeline and Implementation

Given the quantity and significance of the changes to the financial reporting process with respect to KAM, implementing a planning process may enable a smooth and effective transition. The process should include the external auditor, management and the audit committee (if applicable) because these parties are key to strong financial reporting and governance. An example of an implementation process and timeline, assuming an entity with a December 31 year-end, might look like the following:



Immediately—Understand how the changes affect the entity

Auditors, management and TCWG, including audit committees (the parties) may consider meeting to discuss how KAM will affect the entity and the external audit. Some of the topics that might be considered for discussion in this meeting include the following:

- Discuss the merits of KAM reporting and decide whether KAM will be reported in the auditor's report. KAM may need to be reported where law and/or regulations require the auditor to communicate KAM in the auditor's report. The auditor may also decide to communicate KAM in the auditor's report.
- For entities where KAM will be communicated, discuss what KAM will be reported for the entity. When developing an effective process for KAM reporting, it may help to conduct a trial run based on the 2017 year-end audit. During the trial run, the parties could discuss any matters communicated to TCWG to identify potential KAM, and how they might be described in the auditor's report. This trial run will enable the parties to refine the KAM reporting process and be better prepared for the following year, when KAM are to be communicated.

2017 year-end audit— Trial run of the new standards

CAS 701 is effective for audits of financial statements for periods ending on or after December 15, 2018 therefore the 2017 year-end audit will be a good opportunity for a preparatory trial run. Some ideas the parties may consider for this trial-run period include:

- When the auditor will be communicating KAM in the auditor's report, the auditor may consider providing management and TCWG with a list of the matters requiring significant auditor attention during the audit. The auditor could then identify, from those matters, which were of most significance in the audit and therefore would have been communicated as KAM.
- The auditor is encouraged to provide the reasons why those matters were identified as KAM and explain the process used to come up with that determination.
- The auditor may wish to provide a draft of the KAM wording which the parties may review, for example, to confirm factual accuracy, and to decide whether this draft is appropriately balanced.

2018 year-end planning meeting— Plan for a smooth transition

The 2018 year-end audit planning meeting may be an opportunity for the parties to revisit the previous discussions on KAM. This meeting may include discussing the communication process among the auditor, management and the audit committee to enable early identification of KAM. Early communication of potential KAM may help to facilitate a smooth audit process.

2018 year-end audit— Execute

The new auditor reporting standards become effective for audits of financial statements for periods ending on or after December 15, 2018. Some considerations in the first year of applicability include:

- Discuss the draft communication of the identified KAM in the auditor's report, if any, and any related disclosures in the financial statements.
- Discuss any other matters identified by the auditor that could become KAM in the future. Because KAM can change each year, early identification of potential future KAM could be beneficial in planning for audits of future periods.

Illustration of the New Auditor's Report

Although the example below assumes the financial statements are prepared in accordance with International Financial Reporting Standards (IFRSs) and that a comparative financial-statement reporting approach is being used (i.e., opinion on two years), the changes highlighted apply equally in other circumstances.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the consolidated financial statements of ABC Company (the Entity), which comprise the consolidated statement of financial position as at December 31, 20X1 and December 31, 20X0, and the consolidated statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Entity as at December 31, 20X1 and December 31, 20X0, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note X in the consolidated financial statements, which indicates that the Entity incurred a net loss of \$X during the year ended December 31, 20X1 and, as of that date, the Entity's current liabilities exceeded its total assets by \$X. As stated in Note X, these events or conditions, along with other matters as set forth in Note X, indicate that a material uncertainty exists that may cast significant doubt on the Entity's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

auditor's opinion moved from the end of the auditor's report to the very beginning

explicit statement about the auditor's independence in accordance with relevant ethical requirements and the auditor's fulfillment of other ethical responsibilities

separate section when a material uncertainty exists related to an entity's ability to continue as a going concern, and is adequately disclosed in the financial statements

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with CAS 701—Refer to illustrative example of a key audit matter above]

Other Information

*[Reporting in accordance with CAS 720, The Auditor's Responsibilities Relating to Other Information—Refer to CPA Canada's **Audit & Assurance Alert—Other Information** for further details on all of the reporting requirements related to OI including illustrative examples.]*

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

separate section when a material uncertainty exists related to an entity's ability to continue as a going concern, and is adequately disclosed in the financial statements

separate section when an entity prepares other information, such as an annual report, containing or accompanying the entity's financial statements and auditor's report thereon, to explain management's and the auditor's responsibilities for the other information and the auditor's conclusion from reading and considering the other information

enhanced description of management's responsibilities for assessing the entity's ability to continue as a going concern and whether the use of the going-concern basis of accounting is appropriate

identification of those charged with governance, when applicable, and their responsibility for the oversight of the financial reporting process

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements. As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

new description of the auditor's responsibilities to conclude on the appropriateness of management's use of the going-concern basis of accounting

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards.]

The engagement partner on the audit resulting in this independent auditor's report is *[name]*.

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

new description of the auditor's responsibilities in an audit of group financial statements

new description of the auditor's responsibilities regarding communications with TCWG

new description of the auditor's responsibilities to provide a statement to TCWG that the auditor has complied with relevant ethical requirements regarding independence for listed entities

new description of the auditor's responsibilities with respect to communicating key audit matters when CAS 701 is applied

new disclosure of the name of the engagement partner for listed entities

Other Resources

CPA Canada

1. [Audit & Assurance Alert—New and Revised Auditor Reporting Standards](#)
2. [FAQ for Management and Audit Committees—New Auditor Reporting Standards](#)
3. [Guide—Reporting Implications of the CASs](#)

Auditing and Assurance Standards Board (AASB)

1. [Basis for Conclusions: Reporting on Audited Financial Statements—New and Revised Auditor Reporting Standards and Related Conforming Amendments](#)
2. [Auditing and Assurance Bulletin titled “Addressing Disclosures in the Audit of Financial Statements”](#)

Appendix A – Frequently Asked Questions

This FAQ section presents an amended version of the International Auditing and Assurance Standards Board (IAASB) Auditor Reporting Working Group Publication released in March 2016 – *More Informative Auditor’s Reports – What Audit Committees and Finance Executives Need to Know*.

The follow is a summary of the of the most frequently asked questions regarding key audit matters.

1. Are Key Audit Matters Required in Canada?

Canadian Auditing Standard (CAS) 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* was approved by the AASB in April 2017 and is effective for audits of financial statements for periods ending on or after December 15, 2018. The standard applies to audits of complete sets of general purpose financial statements when:

- the auditor decides to communicate key audit matters in the auditor’s report
- the auditor is required by law or regulation to communicate key audit matters in the auditor’s report.

The following is an except taken from the May 2017 AASB Message from the Chair. Click here to see the [complete message](#):

A significant component of the auditor reporting ISAs is a requirement that auditors of listed entities communicate key audit matters—those matters that, in the auditor’s judgment, were of most significance in the audit.

Canadian stakeholders made it clear in a variety of interactions that changes to auditor reporting standards need to recognize that the Canadian and U.S. capital markets are closely integrated. They emphasized that if key audit matter reporting requirements and the entities to which they would apply, are significantly different between Canada and the U.S. this could create confusion in the marketplace and potentially affect comparability of information across the North American capital markets.

The U.S. Public Company Accounting Oversight Board has not finalized its auditor reporting standards, including with respect to a key audit matter reporting concept. As a result, the AASB believes that it is not appropriate at this time to mandate key audit matter reporting for listed entities in Canada.

The final CASs, as adopted, do not contain a key audit matter reporting requirement at this time. They do allow for law or regulation to require reporting of key audit matters and for the auditor to decide to do so.

While there are other differences between the CASs and U.S. reporting standards, the AASB understands, based upon discussions with stakeholders, such differences do not create the same sensitivities as key audit matter reporting.

2. Is the auditor taking on a management role when communicating KAM?

KAM are not a replacement of, or supplement to, management's perspective embodied in the financial statements. The intent is not to "fill the gaps" for disclosures viewed as incomplete or missing—the auditor's consideration of the adequacy and appropriateness of disclosures is part of forming an opinion on the financial statements.

There will often be a link between KAM and areas of complexity or significant judgment in the financial statements. Such is the nature of auditing—a risk-based approach that focuses auditor attention on matters of greatest risk of material misstatement. The intent of KAM is to provide transparency for users as to HOW this affected the auditor's approach to the audit. It's intended to highlight for users the matters that required the most auditor attention so that users can then focus greater attention on how such matters were dealt with.

3. Will the communication of these matters publicly have an impact on the relationship, and the candid dialogue, between the auditor and the audit committee?

A commonly expressed concern is that the communication of KAM may have a negative effect on the auditor's relationship with the audit committee, possibly leading to less candid or robust discussions on auditing and financial reporting matters. However, experience in the UK and elsewhere has shown that requiring auditors to communicate KAM enhances communications about those matters between the auditor and the audit committee, and increases attention by management and the audit committee to the disclosures referred to in the auditor's report.

Audit committees may consider requesting to see a draft of the auditor's report (at least the KAM section) as early as possible to get an understanding for what the auditor may intend to say about the matters and to start a dialogue to discuss the matters.

4. Will investors and other users view KAM as a "scorecard" on management's performance?

Existing auditing standards require the auditor to communicate with audit committees about certain matters. This includes the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. The intent of this communication is a candid discussion with

the audit committee about any observations (including any concerns) the auditor may have about the entity's accounting practices or management's judgments or assumptions underlying critical accounting estimates.

Auditors are required to say something in the auditor's report about how KAM were addressed. However, the specifics of the description are left to the judgment of the auditor. The auditing standards do not require either a lengthy description of the auditor's procedures, nor do they require an indication of the outcome of the procedures or a conclusion on the matter.

Users generally welcome additional transparency and insight from auditors. Others believe that outcomes or conclusions on individual matters can be misconstrued as separate opinions and detract from the auditor's opinion on the financial statements as a whole.

5. How will the auditor deal with significant matters that may not have been publicly disclosed by the entity?

The auditor reporting standards set a very high bar for communicating matters that meet the definition of KAM, as the overall aim of communicating KAM are to provide greater transparency to users of the auditor's report. Such matters must be included in the auditor's report unless law or regulation precludes public disclosure about the matter or, in extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The auditor's decision not to communicate a "sensitive matter" would be informed by a full consideration of the facts and circumstances, along with discussions with management and the audit committee about the possibility of public disclosure by the entity about the matter.

This *Audit & Assurance Alert* presents extracts from the International Auditing and Assurance Standards Board (IAASB) publications titled:

- *Auditor Reporting – Illustrative Key Audit Matters* published by the International Federation of Accountants (IFAC) in April 2015 and is used with permission of IFAC.
- *Determining and Communicating Key Audit Matters* published by the International Federation of Accountants (IFAC) in June 2016 and is used with permission of IFAC.
- *More Informative Auditor’s Reports – What Audit Committees and Finance Executives Need to Know* published by the International Federation of Accountants (IFAC) in March 2016 and is used with permission of IFAC.

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Comments

Comments on this *Audit & Assurance Alert*, or suggestions for future *Alerts* should be sent to:

Mike Wynen, CPA, CA

Principal, Research, Guidance and Support
Audit & Assurance

Chartered Professional Accountants of Canada

277 Wellington Street West

Toronto ON M5V 3H2

Email: mwynen@cpacanada.ca

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