The coming of KAMs

The audit process is about to be radically changed by the new audit reporting standards, highlights **Paul Phenix**

"KAMs" – key audit matters – will be required to be reported by auditors of certain public companies for year ends December 2016 onwards, as part of the new auditor reporting package of Hong Kong Standards on Auditing.

In general, KAMs require the auditors to explain specifically and in considerable detail the following:

- What risks they identified in relation to the specific client and audit;
- How they dealt with those risks during their audit work; and
- What the results or conclusions of that audit work were.

A form of KAM reporting has been in force in the United Kingdom for several years. KAMs are new to Hong Kong, but a small number of Hong Kong-listed companies agreed to their auditor's early adoption for year ends in 2015 and 2016. This novelty is likely to create some confusion; a lot of extra client liaison work; a need for a slightly different audit approach; more audit work; and, of course, higher audit costs.

As members of the Hong Kong Institute of CPAs know, higher audit costs do not always translate into higher audit fees.

Where do these extra audit costs come from and how could they be dealt with?

The table on page 45 sets out the more significant KAM issues and possible actions to deal with them.

Client preparation

Ideally, the client will have been given some indication of the coming of KAMs and its implications for the 2016 audit at the time of the sign-off phase of the 2015 audit or subsequently during 2016. If not, there is no time to spare in alerting them to the coming of KAMs.

Few things will be worse for client relations and for successful audit cost-recovery than for the client to be suddenly hit with significant increases in audit involvement, audit work and audit costs at the pre-audit planning stage. What would be even worse is if it comes up at the audit committee and sign-off phase – or in the fee note.

If any of those circumstances happen, the chances of obtaining higher audit fees and reasonable cost-recovery will be significantly reduced.

Apart from the large issuers, it is likely that most clients, especially those based in China, will not be properly aware of KAMs or of the implications of KAMs for them, their staff and their audited consolidated financial statements.

Most materials on KAMs are in English, and are percieved as being technical and auditor-focused.

In any event, the audit firms should be briefing clients in the appropriate language and location.

More importantly, each client should also be engaged individually at a face-to-face meeting at the earliest opportunity and before the pre-audit meeting with the audit committee.

It is important that this meeting is with the board and is not a technical briefing. It is perhaps the most critical piece of client relations work in many years.

Failure to get the client, including their board, audit committee and accounting staff, to appreciate the implications of KAMs for their scheduling, their staff and competences will significantly affect the timing and costs of the audited financial statements.

Also, it is easy to imagine the potential reaction of clients who learn that their auditor will report publicly on possible risks and problems in their company and will explain their audit work and opinion.

The significance of "their company" is greater in Hong Kong than in the West because of the preponderance of family-owned and managed companies.

Staff preparation

It is likely that staff will have already received technical training on the KAM package of new auditing standards.

This training should be reinforced before the 2016 audit season with further sessions on the likely practical issues during planning, execution and sign-off, with a particular focus on the soft skills of client relationship management.

Skills

The KAM requirements are technical but are expected to be written into the audit opinion in non-technical, conversational English. It is widely remarked that many Hong Kong people could have difficulties with this form of English.

Another problem is that such English KAM statements will have to be translated into one or both forms of Chinese for the consolidated financial statements and Stock Exchange of Hong Kong announcements.

Possible responses are:

- To translate information available on KAMs into one or both forms of Chinese; and
- To identify staff who are capable in

Key actions of KAMs

External: Clients

Issues	Necessary or possible actions
Client is not fully aware of KAMs.	Hold briefing sessions with clients; can be in a group setting.
Client does not speak or read English, yet almost all information on KAMs is in English.	• Briefing in Cantonese or Putonghua; and • Translate information.
Client does not fully realize the implications of KAMs, such as: • Extra time and costs in planning stage; • Extra time and costs in sign-off phase (may take two weeks longer); • Possible problems in filing deadlines; and • The requirement for an engagement partner's significant time which leads to higher audit costs and fees.	Speak to each client separately and ensure the following is done: • Explain new audit reporting system; • Clearly identify the effect on client's procedures and time tables and the audit committee and sign-off process; • Clarify that documents are needed earlier (may be by two weeks); • Explain extra time or costs arising for the client and for auditor; • Explain fee implications of extra time or costs; • Clarify that client needs to ensure top executives are available for the extended audit committee and sign-off phase; and • Explain unplanned extra time or costs that arise during the audit.

Internal: Resources

Issues	Necessary or possible actions
When training staff, most available information is in English.	Translate external technical and training information on KAMs.
When recognizing KAM issues in the planning, the audit committee and sign-off phase will take much longer than before.	Planning itself will take longer, so potential KAMs must be identified more clearly.
KAMs are in technical, discursive or conversational English.	Identify staff who write good English: • Make them KAM specialists; and • Organize a centralized specialist team to deal with KAMs.
KAMs are specific to each client and each period: • Templates not as useful or not available; and • Any templates will need adaption.	• Build library of KAMs based on U.K. examples; and • Modify U.K. examples as basis of possible Hong Kong templates.
Devise plan to deal with KAMs, for example: • First draft by the specific audit team; • Final draft by specialist or tech team; or • Use outside English consultants.	• Each audit team with at least one competent English writer; • Referral to a centralized specialist KAM team; or • Identify potential English consultants.

- writing the required English style, and ensure that each audit team has one such person; or has access to one or to a specialist English writer.

When planning staff for each audit team, it should be recongnized that any specialist English writer will have a heavy workload during the financial reporting season. Firms could explore secondments to Hong Kong of native-English staff from the Western firms in their network.

It would also be helpful to form a special KAM unit at the firm level which would write the final versions of KAMs based on each audit team's initial draft. This specialist unit could engage external professional English writers to assist in polishing of the KAM reports and Chinese specialists to do the translation.

Timing

All of this discussion, editing and polishing will add considerable time and costs to the audit because it will be done at the more senior, more expensive levels of the audit firm.

It will have similar effects on the client's executive team and audit committee and the client must recognize that pressure, preferably as early as possible and, at least, at the audit planning stage.

Given that relatively simple modifications to audit opinions under existing standards seem to take several days to discuss with management and agree with the audit committee, it is likely that the KAMs themselves may take one or two weeks to finalize.

Planning

As auditors and preparers are fully aware, planning and preparation are critical to the outcome of a successful, on-time audit.

All the implications, plans and arrangements identified will have to be incorporated into:

- Firm-level planning of the allocation of staff and resources to particular audits;
- Firm-level decisions on a specialist KAM team and associated referral procedures; and
- An audit team level planning to allocate adequate time for:
  - Making each client fully aware of the issues and implications;
  - Dealing with KAMs during the audit committee and sign-off phase; and
  - Keeping the client informed of changes in the audit plan (i.e. more time or costs) if new or enhanced KAMs are identified during the audit.

Library of KAMs

As support for the planning processes, for the audit teams and for any specialist KAM team, it is advisable for the firm to collect a library of examples of actual KAMs drawn from U.K.-listed companies which have been reporting KAMs in recent years. You will see that KAM audit reports often run into four or five pages.

It should be possible to develop broad templates from those examples which fit the Hong Kong situation and that of each firm's major clients.

But it is important to impress upon staff that KAMs are particular to each audit and to any given year: templates have to be used with more caution than in earlier years.

Audit committee and sign-off phase

This will be the second critical phase of the audit process and the one where the client's effective preparation for KAMs will pay off.

As noted previously, directors of Hong Kong companies are usually owners and are understandably proprietary about their company and the information that is made public about their company.

KAMs will examine key aspects of the business model and how it is run. Incorporating this kind of information in the audit opinion on consolidated financial statements could be seen as exposing commercial secrets to competitors, and the owner-directors are certain to take a keen hands-on interest in what will be said in the KAMs. This could lead to uncomfortable or difficult discussions during the audit finalization process. There will certainly be significant challenges for the audit committee, its chairman and the auditor.

Timing

If a firm has not been laying the ground-work by preparing clients, staff and their audit procedures for KAMs, it should begin doing that immediately so as to minimize difficulties in the audit.

For a set of summaries of the KAM package of International Standards on Auditing published by IFAC, visit *www.ifac.org/publications-resources/determining-and-communicating-key-audit-matters*.

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