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# Lessons Learned from Firms Implementing KAM Communications on Audits of TSX-Listed Entities

Identifying and Communicating KAMs  
in the Auditor's Report

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April 2021

This non-authoritative guidance has been prepared by staff of the Auditing and Assurance Standards Board (AASB). It does not form part of the CPA Canada Handbook – Assurance. Auditors are expected to use professional judgment in determining whether to apply the material in this guidance in the circumstances of their audit engagements.

### Introduction

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Communicating KAMs in the auditor's report is the biggest change to the auditor's report that the profession has seen in the last ten years. While KAM requirements have been in effect in jurisdictions around the world for about four years, it is a relatively new requirement for Canadian auditors and the last phase of the enhanced auditor reporting project.

Canadian accounting firms have been developing a KAM-implementation process and performing "practice runs" as they prepared to communicate KAMs in the auditor's report of entities listed on the Toronto Stock Exchange (TSX).

Firms that performed practice runs said it was a beneficial experience. They gathered initial feedback on their processes, including firm tools and guidance that has been developed to support implementing KAM communications. Firms indicated that management and the audit committee also benefited from the practice runs, helping them understand what to expect once the requirements become effective.

Staff of the AASB interviewed firm representatives from the department of professional practice, or the equivalent, to understand:

- the challenges faced during the practice runs;
- what went well when implementing the established processes; and
- what firms will do differently in the live setting.

The feedback was consistent from all firms: identifying and communicating KAMs is not easy!

Staff of the AASB leveraged the input received to create this guidance, which is broken down into two sections.

### Section 1: Identifying KAMs

When identifying KAMs, the auditor starts with all matters communicated with those charged with governance. The auditor then exercises professional judgment to determine which matters were of most significance in the audit of the current period financial statements.

**Figure 1** shows how to identify a KAM through a filtering process.

### Section 2: Describing KAMs

The auditor exercises professional judgment to describe a KAM. The description of a KAM provides a succinct and balanced explanation that allows intended users of the financial statements to understand why the matter was one of most significance in the audit of the current period and how the matter was addressed in the audit.

The auditor seeks the right balance between providing too much information (which may confuse users) and too little information (which may affect users' understanding) when describing the KAM. This section outlines:

- requirements in the auditing standard for describing each KAM;
- related application material; and
- considerations for how to meet the requirements, based on the firms' practice runs

### Overview

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Canadian Auditing Standard (CAS) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, addresses the auditor's responsibility to communicate KAMs in the auditor's report.

This CAS applies to audits of complete sets of listed entities' general-purpose financial statements. It excludes listed entities required to comply with National Instrument (NI) 81-106, *Investment Fund Continuous Disclosure*.

This CAS also applies when the auditor decides to communicate KAMs in the auditor's report or when the auditor is required by law or regulation to communicate KAMs in the auditor's report.

### Effective Date

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CAS 701 is effective for audits of financial statements of:

- TSX-listed entities, excluding listed entities required to comply with NI 81-106, for periods ending on or after December 15, 2020.
- Other listed entities,<sup>1</sup> excluding listed entities required to comply with NI 81-106, for periods ending on or after December 15, 2022.
- All entities for periods ending on or after December 15, 2018, when:
  - the auditor decides to communicate KAMs in the auditor's report; or
  - the auditor is required by law or regulation to communicate KAMs in the auditor's report.

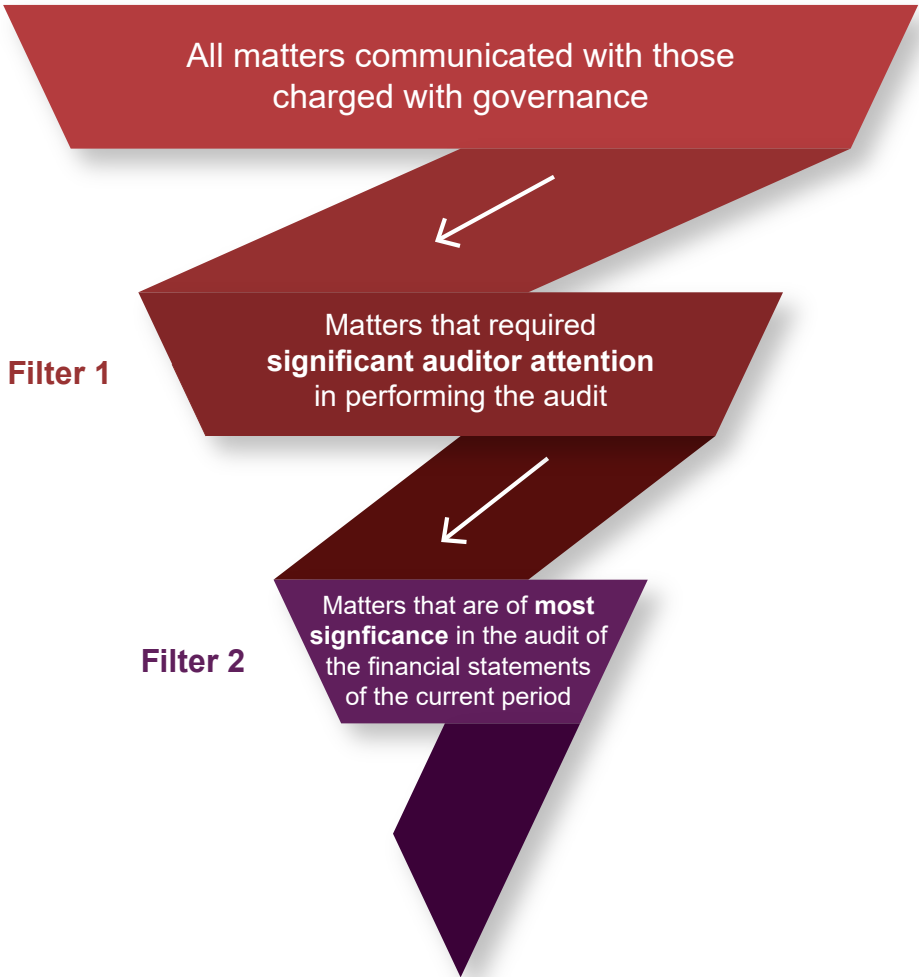
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<sup>1</sup> The CPA Canada Handbook – Assurance, Glossary of Terms, defines a "listed entity" as "an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body." Other listed entities include all entities listed on exchanges other than the TSX (i.e., TSX Venture Exchange, Canadian Securities Exchange, Aequis NEO Exchange).

## Section 1 – Identifying KAMS

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Figure 1



### Matters communicated with those charged with governance

[Paragraphs 14-C17](#) of CAS 260, *Communication with Those Charged with Governance*, list matters the auditor is required to communicate with those charged with governance. [Appendix 1](#) of CAS 260 identifies paragraphs in Canadian Standard on Quality Control (CSQC) 1, *Quality Control for Firms that Perform Audits or Reviews of Financial Statements, and Other Assurance Engagements*,<sup>2</sup> and other CASs that require the communication of specific matters with those charged with governance.

In addition to the required communications with those charged with governance, the auditor needs to identify any other matters communicated to determine the **entire population** of matters communicated with those charged with governance.

### Filter 1: Matters that required significant auditor attention in performing the audit

To determine “significant auditor attention,” the auditor is required to consider the following items.

#### Areas of higher assessed risk of material misstatement

[Paragraph 9](#) of CAS 701 requires the auditor, when identifying matters that required significant auditor attention, to consider the areas of higher assessed risk of material misstatement (which include significant risks). The higher the risk of material misstatement, the more persuasive the audit evidence needs to be. Therefore, more auditor attention is placed in areas of higher assessed risks of material misstatement. [Paragraph 12\(l\)](#) of CAS 315, *Identifying and Assessing Risks of Material Misstatement*, defines significant risk.

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<sup>2</sup> The AASB approved Canadian Standard on Quality Management (CSQM) 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* in January 2021. CSQM 1 is effective as follows:

- Firms are required to design and implement their system of quality management for audits or reviews of financial statements or other assurance engagements by December 15, 2022. They are required to evaluate their system within one year following this date.
- Firms are required to design and implement their system of quality management for related services engagements by December 15, 2023. They are required to be evaluated within one year following this date. They are required to evaluate their system within one year following this date.

### **Areas of significant risk of material misstatement**

[Paragraphs A218-A220](#) of CAS 315 provide guidance for the auditor in determining significant risks. The determination of which of the assessed risks of material misstatement are close to the upper end of the spectrum of inherent risk, and are therefore significant risks, is a matter of professional judgment, unless the risk is of a type specified to be treated as a significant risk in accordance with another CAS. For example, [paragraphs 26-28](#) of CAS 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, provide requirements and guidance for identifying and assessing the risk of material misstatement due to fraud.

### **Significant auditor judgments relating to areas in the financial statements that involve significant management judgment**

[Paragraph 9](#) of CAS 701 requires the auditor, when identifying those matters that required significant auditor attention, to consider the significant auditor judgments related to areas in the financial statements that involved significant management judgment. Certain accounting estimates subject to a high degree of estimation uncertainty may not be determined to be significant risks. Such estimates depend highly on management judgment and are often the most complex areas of the financial statements.

### **The effect on the audit of significant events or transactions that occurred during the period**

[Paragraph 9](#) of CAS 701 requires the auditor, when identifying those matters that required significant auditor attention, to consider significant events and transactions.

Events or transactions that had a significant effect on the audit may be areas of significant auditor attention and may be identified as significant risks. Management may have made difficult or complex judgments related to recognition, measurement, presentation or disclosure of these events or transactions. For example, the auditor may have had extensive discussions with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity.

Significant economic, accounting, regulatory, industry or other developments that affected management's assumptions or judgments may also affect the auditor's overall approach to the audit and result in a matter requiring significant auditor attention.



### **Filter 2: Matters that are of most significance in the audit of the financial statements of the current period**

#### **Determine matters of most significance in the audit of the current period**

After the auditor has identified those matters that required significant auditor attention, [paragraph 10](#) of CAS 701 requires the auditor to determine which of those matters were **of most significance in the audit** of the financial statements of the current period and, therefore, KAMs.

In assessing the relative significance of a matter communicated with those charged with governance, and whether the matter is a KAM, the auditor may consider the following:

- The nature and extent of communication about such matters with those charged with governance. If the auditor has robust, frequent and in-depth discussions with those charged with governance on a particular matter (e.g., a significant business combination), it is most likely a matter of most significance in the audit of the current period.
- The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry.
- 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 and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter.
- The nature and extent of audit effort needed to address the matter, including:
  - The extent of specialized skills or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
  - The nature of consultations outside the engagement team regarding the matter.
- 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.

- Whether the matter involved several separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation or other contingencies, and may also affect other accounting estimates, for example, forecasted future cash flows used in impairment assessments.

## Section 2 – Describing KAMs

Requirement in CAS 701	Application Material in CAS 701	Consider These Lessons Learned from KAM Practice Runs
<p>N/A – Overall description of a KAM</p>	<ul style="list-style-type: none"> <li>The auditor exercises professional judgment when describing a KAM. It is a succinct and balanced explanation that allows the intended users to understand why the matter was one of most significance in the audit of the financial statements of the current period and how the matter was addressed in the audit.</li> </ul>	<ul style="list-style-type: none"> <li>Include subheadings like:                             <ul style="list-style-type: none"> <li>“Description of the Key Audit Matter”;</li> <li>“Why the Matter Is a Key Audit Matter”;</li> <li>and</li> <li>“How the Key Audit Matter Was Addressed in the Audit.”</li> </ul> <p>Subheadings may help the auditor meet the requirements and may make the KAM clearer for the intended users.</p> </li> <li>Focus on the intended users. Use plain English and avoid auditor jargon.</li> <li>Make the KAM as entity-specific as possible. Relate it to the facts and circumstances of the audit of the financial statements of the current period. This may include tailoring the KAM to the entity by using product and subsidiary names, or unique entity factors in the description. Consider whether such detail is original information<sup>3</sup> or has been used in another document. For example, if the KAM relates to a specific subsidiary’s goodwill impairment, use the name or other identifier in the description, provided the information is also in the financial statements or another public document, like the management discussion and analysis.</li> </ul>

<sup>3</sup> Paragraph A35 of CAS 701: “Original information is 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). Such information is the responsibility of the entity’s management and those charged with governance.”

Requirement in CAS 701	Application Material in CAS 701	Consider These Lessons Learned from KAM Practice Runs
<p><u>Paragraph 13</u> – Reference to the related disclosures, if any, in the financial statements</p>	<ul style="list-style-type: none"> <li>• A reference to related disclosures helps the intended users better understand how management has addressed the matter in preparing the financial statements.</li> <li>• Management or those charged with governance may decide to include new or enhanced disclosures in the financial statements or in other documents, because the matter will be communicated in the auditor’s report as a KAM. Examples of such disclosures could be providing more robust information about the sensitivity of key assumptions used in accounting estimates or the entity’s rationale for a particular accounting practice or policy, when acceptable alternatives exist under the applicable financial reporting framework.</li> </ul>	<ul style="list-style-type: none"> <li>• Keep the titles of the KAM and the note disclosure consistent to help understanding and to cross-reference to the financial statement note.</li> <li>• Select parts of the note disclosure that are relevant to the KAM, so the description is tailored and focused. The auditor should not simply reiterate what is already disclosed in the financial statements.</li> </ul>

Requirement in CAS 701	Application Material in CAS 701	Consider These Lessons Learned from KAM Practice Runs
<p><u>Paragraph 13(a)</u> – Why the matter was considered to be one of most significance in the audit of the current period and therefore determined to be a KAM</p>	<ul style="list-style-type: none"> <li>• The KAM explains why the matter is considered one of most significance in the audit of the current period. The auditor may include factors that explain why the matter required significant auditor attention and was of most significance in the audit of the current period.</li> <li>• These factors may include:                             <ul style="list-style-type: none"> <li>○ economic conditions that affected the auditor’s ability to obtain audit evidence, like illiquid markets for certain financial instruments;</li> <li>○ new or emerging accounting policies, like entity- or industry-specific matters on which the engagement team consulted others within the audit firm; and</li> <li>○ changes in the entity’s strategy or business model that had a material effect on the financial statements.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Insert the subheading “Why the Matter Is a Key Audit Matter.”</li> <li>• Identify the reason by referencing the three areas for identifying potential KAMs set out in <u>paragraphs 9</u> and <u>A9-A26</u> of CAS 701, and <u>Filter 1</u> on page 7.</li> <li>• Describe the most important factors in determining that the matters were of most significance in the audit of the current period set out in <u>paragraphs A27-A30</u> of CAS 701 and <u>Filter 2</u> on page 9.</li> </ul>

Requirement in CAS 701	Application Material in CAS 701	Consider These Lessons Learned from KAM Practice Runs
<p><u>Paragraph 13(b)</u> – How the matter was addressed in the audit</p>	<ul style="list-style-type: none"> <li>• Deciding on the detail included in the auditor’s report to describe how a KAM was addressed in the audit requires professional judgment.</li> <li>• The auditor may describe:                             <ul style="list-style-type: none"> <li>○ aspects of the auditor’s response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement;</li> <li>○ a brief overview of procedures performed;</li> <li>○ an indication of the outcome of the auditor’s procedures; and</li> <li>○ key observations with respect to the matter.</li> </ul> </li> <li>• Avoid using auditing jargon to help intended users understand the basis for the auditor’s focus on particular matters during the audit.</li> <li>• Exercise care so that the language used in the description:                             <ul style="list-style-type: none"> <li>○ Does not imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements.</li> <li>○ Relates the matter directly to the entity’s specific circumstances and avoids generic or standardized language.</li> <li>○ Considers how the matter is addressed in the related disclosure(s) in the financial statements, if any.</li> <li>○ Does not contain or imply discrete opinions on separate elements of the financial statements.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Insert the subheading “How the Key Audit Matter Was Addressed in the Audit.”</li> <li>• The amount of detail included in the KAM depends on the circumstances of the entity and the complexity of the audit procedures. When describing audit procedures, consider the following:                             <ul style="list-style-type: none"> <li>○ Avoid writing a “laundry list” of audit procedures performed. Focus on the primary procedures and those directed at evaluating management’s key assumptions, judgments or inputs. Include a lead-in sentence that indicates the procedures described are the primary but not all procedures performed to address the KAM.</li> <li>○ Avoid using auditor jargon. For example, “cut-off testing”, “dual purpose testing”, “write-off”, “turnover, completeness”, “existence, classification and/or ownership and rights” may not be well understood by the intended user.</li> <li>○ Describe the audit procedures performed in a logical manner to make the KAM clearer. For example, describe tests of controls first, followed by substantive procedures.</li> <li>○ Describe the aspects of the audit procedures specific to the risk of material misstatement. For example, when assessing the appropriateness of the key assumptions used in management’s impairment analysis, it may not be enough to simply indicate the auditor assessed the appropriateness of the discount rate used. Consider including more detail to explain how the rate was tested. For example, include how the discount rate was compared to a discount rate independently developed using public data.</li> <li>○ If an expert was involved in performing audit procedures relating to the KAM, consider including this detail in the KAM itself.</li> </ul> </li> </ul>

### Other Resources

The resources listed below provide further guidance on KAMs:

1. Australian Auditing and Assurance Standards Board. [Auditor Reporting FAQs, Australian AUASB website.](#)
2. CPA Canada. "Key Audit Matters." Chap. 13 in [Reporting Implications of the Canadian Auditing Standards](#), 4<sup>th</sup> edn. 2019.
3. International Auditing and Assurance Standard Board. [Auditor Reporting – Key Audit Matters](#). January 30, 2015.
4. New Zealand External Reporting Board and Financial Markets Authority. [Enhanced auditor reporting: A review of the third year of the revised auditor's report](#). May 2020.

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