

STANDARD ON AUDITING- 701

COMMUNICATING KEY AUDIT MATTERS

KEY AUDIT MATTERS (KAM)

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 audit period*.

Key audit matters are *selected from matters communicated with those charged with governance*.

This is the most significant change introduced by the new requirements.

PURPOSE OF COMMUNICATING KAM

Enhancing the *communicative value* of the report of the auditor by offering *better transparency* about the audit which was executed.

It offers *additional information to users* of such financial statements in assisting them *to understand those matters which in the professional judgment of the auditor,* were of critical importance in the audit of financial statements of the relevant period.

It might also assist the users of such financial statements to understand the entity and *help in understanding the areas of crucial management judgment* in such audited financial statements.

APPLICABILITY OF KAM



- This New SA 701, Communicating Key Audit Matters in the Independent Auditor's Report, is effective for annual audits of financial statements for periods beginning on or after April 1, 2018.
- It casts a new reporting requirement on auditors of listed entities (including listed entities outside India) to communicate the key audit matters in their audit reports.
- This Standard is also applicable in audit of unlisted entities in situations where law or regulation requires communication of key audit matters in the audit report.

DETERMINATION OF KAM



**KEY AUDIT
MATTERS**



Matters that are
communicated to those
charged with governance

Matters that required
significant auditor attention

Matters of most
significance in the audit

SOME COMMON KEY
AUDIT MATTERS
REPORTED TILL THE DATE

Information Technology (IT) and controls impacting financial reporting



Example: AU Small Finance Bank Limited

IT systems and controls

The reliability and security of IT systems plays a key role in the business operations of the Bank. Since large volume of transactions are processed daily, the IT controls are required to ensure that applications process data as expected and that changes are made in an appropriate manner. These systems also *play a key role in the financial accounting and reporting process of the Bank.* Due to the pervasive nature and complexity of the IT environment we have ascertained IT systems and controls as a key audit matter. Our areas of audit focus included *user access management, developer access to the production environment and changes to the IT environment.* These are key to ensuring IT dependent and application-based controls are operating effectively.

Example: AU Small Finance Bank Limited

➤ How audit addressed the key audit matter

- For testing the IT general controls, application controls and IT dependent manual controls, we ***included specialized IT auditors*** as part of our audit team. The specialized team also assisted in testing the accuracy of the information produced by the Bank's IT systems.
- Tested the design and ***operating effectiveness of the Bank's IT access controls*** over the information systems that are critical to financial reporting.
- Tested IT general controls (***logical access, changes management and aspects of IT operational controls***). This included testing that requests for access to systems were reviewed and authorized.
- We considered the control environment relating to various interfaces, configuration and other application controls identified as key to our audit.
- In addition to the above, we ***tested the design and operating effectiveness of certain automated controls*** that were considered as key internal controls over financial reporting.
- Where deficiencies were identified, ***we tested compensating controls or performed alternate procedures.***

Impact of COVID-19 Pandemic



Muthoot Finance

Example: LIC Housing Finance Limited

➤ Impact of COVID-19 pandemic

Due to the national lockdown in India, *the information necessary for conducting the audit was provided by the Company remotely through a secure connection and suitable IT systems were made available to us.* As a result, we have relied completely on digital or electronic evidence as a part of our audit process effective from the date of the lockdown till the date of this report.

Example: LIC Housing Finance Limited

➤ How audit addressed the key audit matter

We have carried out the validation of the electronic evidence provided by the management by performing the following procedures:

- a. We reviewed the steps taken by various Departments of the Company ***to ensure that the controls and operations were functioning effectively in the period of the lockdown.***
- b. We have correlated the ***electronic evidence obtained with the financial information to ensure consistency and accuracy.***
- c. We have obtained management representations wherever considered necessary.

Revenue Recognition



Chennai Petroleum Corporation
(A group company)



NOCIL LIMITED



Example: NOCIL Limited

➤ Revenue recognition and measurement

For the year ended March 31, 2020, the Company recognised revenues from sale of goods aggregating to Rs. 83,775 Lakhs (previous year Rs. 103,036 Lakhs).

The Company recognises revenue from sale of goods when the amount of revenue can be reliably measured, it is probable that future economic benefits will flow to the entity and the products have been delivered to the customer. Amounts disclosed as revenue are net of customer returns, trade allowance, rebates, goods and services tax and amount collected on behalf of third parties.

Risk identified:

Revenue is recognized when control of the underlying goods is transferred to the customer. There may be a ***risk of revenue being overstated due to pressure from Management to achieve performance targets at the reporting period end.***

Example: NOCIL Limited

➤ How audit addressed the key audit matter

Our procedures included:

Accounting policies: Assessing the Company's revenue recognition policies, including those related to commission discounts, rebates and returns by comparing with the applicable Ind AS.

Tests of controls:

Evaluating the design and testing the ***operating effectiveness of controls over the accuracy of commission discounts, incentives and rebates and correct timing of revenue recognition.***

Tests of details:

- Verifying the supporting documentation for determining that the revenue was recognised in the ***correct accounting period.***
- Comparing the commission discounts, incentives and rebates with the prior year and, where relevant, performed further inquiries and testing.
- Verifying the ***manual journals posted to revenue*** to identify unusual or irregular items.

Example: NOCIL Limited

➤ How audit addressed the key audit matter (continued)

- To assess the *recoverability of trade receivables*, our procedures included an assessment of whether the provision against, or write off, impacted our view as to the initial recognition of the related revenue.

Performing substantive analytical procedures:

Developing an expectation of the current year revenue based on trend analysis and recent market conditions and growth of the Company and compared the same with the actuals, accompanied with further inquiries and testing.

We also assessed as to whether the disclosures in respect of revenue were adequate.

Valuation of Inventories



Example: Bata India Limited

➤ Net realisable value (NRV) of Inventories of finished goods

The major part *Company's inventory comprises finished goods which are geographically spread across multiple locations such as retail stores, depots and factories.*

These inventories are *counted by the Company on a cyclical basis* and determination of NRV is made based on various estimates (including those related to obsolescence of slow and non-moving inventory) by the Company as at end of reporting period.

The Company *manufactures and sells goods which are subject to changing consumer demands and fashion trends. Significant degree of judgment* is thereby required to assess the NRV of the inventories and appropriate write down of items which may be ultimately sold below their cost. Such judgment includes *Company's expectations for future sale volumes, inventory liquidation plans and future selling prices less cost to sell.*

In view of the above, assessment of NRV and its consequential impact, if any on the carrying value of inventories of finished goods has been identified as a key audit matter.

Example: Bata India Limited

➤ How audit addressed the key audit matter

In view of the significance of the matter we applied the following audit procedures in this area, among others to obtain sufficient appropriate audit evidence:

A) Assessed the appropriateness of the accounting policy for inventories as per relevant accounting standards.

B) Evaluated the design and implementation of key internal financial controls with respect ***to determination of NRV for slow and non-moving inventory as well as inventory with low or negative gross margins*** and tested the operating effectiveness of such controls on selected transactions.

C) On a sample basis, assessed whether items in the ***inventory ageing report prepared by the Company were classified within the appropriate ageing bracket.***

D) Assessed the methodology and assumptions adopted by the management including ***retrospective review of the write down of slow and non-moving inventory by comparing the selling prices of goods sold during the year*** with opening carrying values.

E) Assessed, on a sample basis, the net realisable value of slow moving and obsolete inventories and inventories with low or negative gross margins as calculated by the Company by comparing the carrying value with their subsequent selling prices and costs to sell subsequent to the year-end.

SOME OTHER COMMON KEY AUDIT MATTERS

- ✓ Impairment Assessment of carrying amount of Property, Plant and Equipment (PPE) and Capital Work in Progress (CWIP)
- ✓ Impairment of Trade Receivables
- ✓ Transition to Ind AS 116 'Leases' with effect from 1 April 2019
- ✓ Disclosure of Related Party Transactions
- ✓ Uncertain Tax positions
- ✓ Impairment allowance of Loan Assets (Specifically in Banking/Finance Industry)
- ✓ Valuation of Investments (Specifically in Banking/Finance Industry)
- ✓ Payroll Processing & Retirement Benefits
- ✓ Fair valuation of Derivative Financial Instruments
- ✓ Identification of Non-Performing Advances and provisioning for Advances
- ✓ Impairment testing of investment in subsidiary

THANK YOU

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