



BI Norwegian Business School - campus Oslo

# GRA 19502

Master Thesis

Component of continuous assessment: Thesis Master of Science

The reporting practices of Key Audit Matters in the big five audit firms in Norway

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Start: 02.03.2017 09.00

Finish: 01.09.2017 12.00

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# The reporting practices of Key Audit Matters in the big five audit firms in Norway

June 30<sup>th</sup> 2017

Programme: Master of Science in Business

Major in Business Law, Tax and Accounting

*This thesis is a part of the MSc programme at BI Norwegian Business School. The school takes no responsibility for the methods used, results found or conclusions drawn.*

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## Acknowledgements

This master thesis represents the end of a Master of Science degree in Business with major in Business Law, Tax and Accounting at BI Norwegian Business School. This is however only the beginning of a, hopefully, long career in auditing for the both of us. As of August 2017, we begin our careers as audit associates in KPMG Norway, and we look forward to employing the knowledge gained through the process of writing this thesis.

The thesis consists of 30 ECTS credits and is written during the last semester of the study program, the spring of 2017. The process of writing this thesis has demanded hard work and dedication. It has resulted in a great understanding of, and interest for, a highly relevant topic.

We especially want to show our most sincere appreciation and gratitude toward our supervisor Flemming Ruud, PhD, for helping us with great insight, suggestions and support throughout the whole process. We also have to give our heartfelt thanks to each representative from the big five audit firms for participating in our interviews. Their time and knowledge has given valuable insight into the audit processes of each company. It has also provided a broader understanding of key audit matters. Lastly, we would like to thank KPMG for guiding us through the process and for giving us the opportunity to work on this master thesis at their offices.

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## Summary

As of December 15<sup>th</sup> 2016, the audit reporting requirements in Norway have changed in a number of aspects. The most substantial change is the reporting of Key Audit Matters (KAM). ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, is mandatory for listed companies in Norway as of December 15<sup>th</sup> 2016 (IAASB, 2015B).

The purpose of this thesis is to investigate the differences in the reporting practices of key audit matters between the big five audit firms in Norway (BDO, Deloitte, EY, KPMG and PwC). Furthermore, the thesis examines, and attempts to explain, why such differences exist.

The findings of this study reveal that the number of reported key audit matters differ between the big five audit firms in Norway. On average, EY reports the fewest KAMs (1.59 KAMs), while KPMG report the most (2.75 KAMs). The type of KAMs reported also seem to differ between the audit firms. However, certain KAMs recur, such as 'impairment of assets', 'goodwill impairment' and 'revenue recognition'.

The thesis identifies differences between the audit firms in the descriptions of key audit matters. While certain audit firms describe KAMs in detail, others describe KAMs briefly and less detailed. The descriptions of 'how the matter was addressed in the audit' are also varying in terms of granularity between the audit firms. All of the big five audit firms explain that they have placed more focus on describing 'how the matter was addressed in the audit' rather than describing the KAMs.

Slight differences in the use of advanced language in the KAM section is detected between the five audit firms. The presentation format of the KAM section appears relatively similar between the audit firms. However, EY differs in this area by describing the KAM section with plain text.

The overall conclusion of this thesis is that there are differences in the reporting practices of KAM between the big five audit firms in Norway.



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**List of abbreviations**

AR	Audit Response
CPA	Certified Public Accountant
DnR	Den Norske Revisorforening
FRC	Financial Reporting Council
FSTE	Financial Times Stock Exchange
GAAS	Generally Accepted Auditing Standards
IAASB	International Auditing and Assurance Standards Board
IFAC	International Federation of Accountants
IMA	Investment Management Association
ISA	International Standards on Auditing
KAM	Key Audit Matter
PLC	Public Limited Company

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## 1.0 Introduction

The financial crisis that erupted in 2007, described by the European Commission (2011) as one of the worst in modern history since the Great Depression of the 30's, illustrated major weaknesses in the financial sector. Only during the first twelve months of the crisis, € 4.589 billion of tax revenue were spent helping banks to avoid bankruptcy (European Commission, 2011). This represents 39 % of the GDP of the 27 member states of the EU. Despite this, the majority of the annual reports of banks received clean audit reports (European Commission, 2010). This was one of the main reasons why the accounting and auditing professions faced considerable criticism in the aftermath of the crisis. The discrepancy between clean audit reports and banks' economic problems gave rise to a discussion on how we should change the current legal framework relating to the statutory audit in order to prevent new crises from occurring in the future.

Critics were of the impression that auditors should have communicated the problems at an earlier stage (FAR, 2013). Lee, Ali, & Bien (2009) suggest that stakeholders have a tendency to regard a clean audit report as a guarantor of the morale of the audited company and continued vitality. Should the audited company then end up in financial trouble, the universal perception is usually that the auditor has neglected its duties. Such expectations of the audit and the auditor's role are not in line with the actual tasks of the auditor, and have been identified in several studies where this incident is often called the audit expectation gap (Porter, Ó hÓgartaigh, & Baskerville, 2012). To this day, the auditor's role and responsibility is still an ongoing discussion.

The objective of an external audit is to express an opinion on the truth and fairness of the financial statement and assure stakeholders that the entity's financial statements are free from material misstatements (Bhattacharjee, Moreno, & Yardley, 2005). The auditor should increase the financial statement users' confidence that the accounts are prepared in accordance with law and regulations for financial reporting, and are without significant errors (IAASB, 2009A). The result of the audit is an audit report. The audit report is a written statement that conveys the results of the completed audit, and its purpose is to present the auditor's conclusion regarding the revised entity's financial position (Lin, Tang, &

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Xiao, 2003). The design of the audit report is regulated by numerous standards, and takes different forms. However, the standard 'unmodified opinion', also called a clean audit report, is the most common form (Arens, Elder, Beasley, & Hogan, 2017, p. 74).

In recent years, the simple and straightforward form of the audit report has been one of the main reasons for the standard being criticized (IOSCO, 2009). Asare & Wright (2012) claim that limited insight into the auditor's opinion beyond the standard approach will comprise investor's information, and hence, ability to distinguish between firms. They further address that the users of financial statements need specific information on how the auditors transmits the review in order to obtain value of the audit. Church, Davis & McCracken (2008) indicate that even though the audit report has a symbolic value, it does not provide much communicative value to the reader.

In order to meet the users' expectations and requirements for the audit reporting, a process to update the audit report design was initiated by the International Auditing and Assurance Standards Board (IAASB). In June 2012, a draft of the planned changes was published, followed by several discussion rounds where organizations were requested to provide feedback on the proposed changes (IAASB, 2012). IAASB received numerous comments from a wide range of organizations, all commenting on the development of the new audit report. The comments were imminently positive to the changes, although different opinions on the implementation process were raised by several organizations, including audit firms. The audit firms also had different opinions on what the new standard should contain (IAASB, 2015D). After several rounds of processing the suggested reforms, IAASB published in January 2015 the new and revised auditor reporting standards.

As of December 15<sup>th</sup> 2016, the audit report in Norway has changed in a number of aspects. The most substantial change is the introduction of an entirely new section, the reporting of Key Audit Matters (KAMs). This section in the audit report deals with the accounting items, which according to the auditor's assessment were the most significant in the performance of the audit.

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ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* is mandatory for listed companies in Norway on and after December 15<sup>th</sup> 2016 (IAASB, 2015B). A select few audit firms handle the vast majority of the listed companies on the Norwegian stock exchange. These are the largest audit firms in Norway measured by revenue, and are commonly called the 'big five', consisting of BDO, Deloitte, EY, KPMG and PwC. The reporting of key audit matters will be highly relevant for the big five audit firms since a large proportion of their customer base consists of listed companies, subject to ISA 701.

The purpose of ISA 701 is to increase both the auditor's-, and the audit report's communicative value by increasing the transparency of the auditing process. Communicating key audit matters provides additional information to users of the financial statements. The intention is to address both the auditor's judgement as to what to communicate in the audit report, and the form and content of such information. The increased amount of information enclosed in the audit report through KAM opens up for subjective interpretations on what information to include and how to address it. Different approaches and interpretations of ISA 701 can be expected between the audit firms. The objective of this master thesis is to examine the reporting practices of key audit matters in the big five audit firms in Norway. The thesis will explore the differences in the reporting practices of KAM, and attempt to explain why such differences exists.

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## **Disposition**

### Chapter 1 - Introduction

Chapter 1 has been defined to motivate the research area of this thesis. Before presenting the objective of the master thesis, relevant areas of literature are addressed.

### Chapter 2 – The Objectives of Audit and Audit Reporting

The literature that substantiates this thesis is divided into two parts. Both parts are considered essential for the reader's understanding of the audit profession and the new standards on auditing in which the auditor and the audit report are affected. The reader is introduced to general audit theory in chapter 2. This includes the objective of auditing, the audit process, an overview of the current audit report and the audit expectation gap. Differences between ISA 700 (the standard audit report) and ISA 700 Revised (the new audit report) are discussed.

### Chapter 3 – Reporting Key Audit Matters

Chapter 3 specifically targets the key audit matters. The auditing standard regarding KAM (ISA 701) is thoroughly explained as this is the most central part of the thesis. Experiences from the extended audit report in the UK will be discussed, and form the basis for the research questions developed in this thesis.

### Chapter 4 – Research Design and Method

Chapter 4 presents the research design and methodology of this thesis. The methodology aspects that are most central to the research design and empirical findings are thoroughly addressed.

### Chapter 5 – Empirical Findings

The empirical findings of this thesis are presented in chapter 5. This chapter is divided into sections in line with each of the five research questions.

### Chapter 6 - Conclusion

The final chapter presents the conclusion. Practical and theoretical limitations, as well as suggestions for future research, are discussed as an end to this chapter.

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## 2.0 The Objectives of Audit and Audit Reporting

### 2.1 The Auditing Profession

The auditor's work is regulated by the Auditor's Act<sup>1</sup> and associated regulations, and according to §1-2 the auditor is a public trustee that should execute integrity, objectivity and professional diligence. The auditor is imposed to be independent (actual independence) and perceived as independent (perceived independence). This is to increase the financial statement users' trust in the auditor's work and accounts (IAASB, 2009A). According to Den Norske Revisorforeningens (DnR) code of ethics, independence requires the following: "Basic attitude and setting that makes it possible to express a conclusion without being affected by elements that sets the professional judgement in danger, so that a person can act with integrity and execute objectivity and professional scepticism" (DnR, 2017, p. 1052). The auditor should avoid situations where a third party who receives information about the situation, believes that the auditor's integrity, objectivity or professional scepticism is unsatisfactory (DnR, 2017, p. 1052).

The Auditor's Act § 5-2 states that the audit shall be conducted in accordance with the best judgement- and auditing practices. According to Gulden (2015, p. 126), Generally Accepted Auditing Standards<sup>2</sup> (GAAS) can be defined as performing audit procedures in accordance with the perception of ethical and auditory principles that are generally recognized and practiced by skilled and responsible practitioners of the profession. Auditing standards are considered a materialization of such recognized principles and methods, meaning that auditing standards generally govern the practical performance of the audit. The International Auditing and Assurance Standards Board (IAASB) in The International Federation of Accountants (IFAC) publish the International Standards on Auditing (ISA). All ISAs have a similar structure, and consist of an introduction, objective, definition, requirements, guidance and explanatory material, as well as relevant attachments (Eilifsen, Messier, Jr, Glover, & Prawitt, 2013).

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<sup>1</sup> 'Revisorloven', in Norwegian

<sup>2</sup> 'God Revisjonsskikk', in Norwegian

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## ***2.2 The Audit Process***

Rødssæteren claims that an auditor can manage risk by engaging the right clients (lecture BI, 21.04.17). The auditor is required to perform risk assessments of the potential client and avoid high-risk clients. This implies that the audit process begins even before the audit company has accepted a potential client. If the auditor accepts the client, the initial planning, risk assessment and preliminary analytical procedures begins (Arens, Elder, Beasley, & Hogan, 2017, p. 25).

In order to express reasonable assurance that the financial statement are free from material misstatement (IAASB, 2009A), a material misstatement must be defined. According to Arens et al., (2017, p. 84) "A misstatement in the financial statements can be considered material if knowledge of the misstatement would affect a decision of a reasonable user of the statements". It is difficult to know when a misstatement would affect users' financial dispositions, and what is considered material is therefore based on the auditor's professional judgement in each individual case (IAASB, 2009C). In practice, a reference value is often used as a basis for quantifying the materiality. According to Gulden (2016, pp. 100-102) the reference value could for instance be 5-10 % of results before taxes, or 1 % of revenues.

The materiality will affect the risk assessment during the planning phase. The lower the auditor determines the materiality, the higher the risk of material misstatement, and the more extensive it becomes to lower the audit risk to an acceptable level (Gulden, 2016, p. 110). In ISA 200, audit risk is defined as "The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk" (IAASB, 2009A). The auditor's responsibility is hence to lower the audit risk to an acceptable level by determining the inherent risk, performing control tests to determine control risk, and based on the established control risk; perform substantive procedures to influence the detection risk. This forms the basis for assessing the likelihood of misstatements in the financial statement (Arens et al., 2017, p. 25). Accordingly, risk assessment procedures must be carried out to determine where there is greatest likelihood of significant errors. ISA 315 requires the auditor to map and calculate the risks of

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material misstatement due to fraud or error at the financial statement- and assertion level. Identification of these errors will form the basis for initiating actions to handle the estimated risk of material misstatement (IAASB, 2009D). According to ISA 315, required actions include requests for management and other relevant actors, analytical actions and observation, as well as inspection. The auditor should also determine whether the business has a risk assessment process, if it is appropriate, and whether there is a significant shortcoming if the business has no such process (IAASB, 2009D). The auditor will hence better understand the business and will to a greater extent be able to develop expectations related to material misstatements.

If the auditor expects high likelihood for error in the accounts, extensive procedures must be carried out to obtain reasonable assurance that the accounts are free for material misstatement (Gulden, 2016, p. 110). This includes analytical procedures, tests of key items and additional tests of details of balances. The auditor must then accumulate final evidence and evaluate results (Arens et al., 2017, p. 25). By obtaining sufficient and appropriate audit evidence, the auditor achieves reasonable assurance that the financial statement are free from material misstatements (Lecture, Flemming Ruud, 30.08.16).

One of the last steps in the audit process is to issue an audit report that should be communicated to the public. The auditor should communicate the content of the audit report with the audit committee and management before it is published (Arens et al., 2017, p. 25). This thesis will in the following discuss the auditor's communication through the auditor's report.

### ***2.3 The Standard Audit Report***

The audit report is a written statement that conveys the results of the completed audit, and its purpose is to present the auditor's conclusion regarding the revised entity's financial position (Lin, Tang, & Xiao, 2003). The design of the audit report is regulated by numerous standards, and takes generally two different forms; clean and unclean, or; pass and fail (MARC, 2011). Arens et al. (2017, p. 75) claim that the audit reports are more nuanced than a simple pass/fail approach,



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and they present five main categories of audit reports. A 'standard unmodified opinion' is a so-called 'clean' audit report, in which no circumstances have required a modification of the auditor's opinion (Arens et al., 2017, p. 74). If not all the requirements for an unmodified opinion is met, the auditor is not supposed to issue such an audit report. The 'unmodified opinion with emphasis-of-matter explanatory paragraph or non standard wording' meets the criteria of a satisfactory audit, however, the auditor is required to provide additional information on certain relevant matters (Arens et al., 2017, p. 78). If the auditor issues a 'qualified opinion', it is concluded that the financial statements are fairly presented, however the auditor has not been able to perform a satisfactory audit (Arens et al., 2017, p. 78). If the auditor concludes that the financial statements are not fairly presented, an 'adverse opinion' is issued. Lastly, a 'disclaimer opinion' is issued in situations where the auditor is not satisfied that the financial statements are fairly presented, or in situations where the auditor is biased or not independent (Arens et al., 2017, p. 78). As the most common audit report is the 'standard unmodified opinion', also called a clean audit report (Arens et al., 2017, p. 74), this will be emphasized in the following discussion.

A standard unmodified opinion is issued in an uniform wording, which is the reason for the reference to the word 'standard' (Arens et al., 2017, p. 72). The main advantage of a standard audit report is that the auditor's conclusion is presented in a simple and straightforward manner, which makes it easier for the reader to understand (IOSCO, 2009). Several academics argue that a deviation from the standard approach will provide the users with uncertainty as they receive more and other information than expected (Chen, Jones, Michas, Pawlewicz, & Pevzner, 2013). The objective of the report can hence be harder to interpret, and the relevance of the report will decrease (Church, Davis, & McCracken, 2008). The audit report should not add new information, merely verify the information the management present in the financial reports. This is, according to Simnett and Huggins (2014), the foundation of the standardized audit report.

The simple and straightforward form is also one of the main reasons for the standard being criticized (IOSCO, 2009). According to Asare & Wright (2012), limited insight into the auditor's opinion beyond the pass/fail approach will

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comprise investor's information, and hence, ability to distinguish between firms. This implies that the binary nature of the opinion in the current report does not recognize differences in the financial statements between firms (IOSCO, 2009).

Church et al. (2008) claim that the standard audit report has a symbolic value, however, does not provide much communicative value. Coram, Mock, Turner & Gray (2011) states that communicative value is evident when the message intended to be communicated is received by the user. According to Smith & Smith (1971) "communication occurs in financial reporting only if the meanings intended by the information source are assigned to the financial statement messages by the destination". Historically, the standard audit report includes generic and boilerplate language, meaning that the information provided may be difficult for the intended user to interpret. This indicates a low communicative value (Coram et al., 2011). According to Simnett & Huggins (2014), lack of communicative value implies that the auditor possesses richer information about the company and the financial reports, however abstains from communicating this to the user. The audit report represents the auditors work, but it conveys little to no relevant information about the entity and the financial report (Church et al., 2008). Both Geiger (1993) and Smieliauskas & Craig (2008) suggest that the current report is a symbol of the auditors work and reputation, but question its informative value. In order to obtain value of the audit in terms of relevant information, the financial statement user needs more specific information on how the auditors transmits the review (Asare & Wright, 2012). If changes were made in the content and structure of the audit report, the communicative value could improve significantly (Simnett & Huggins, 2014). Corporate transparency contributes to a more efficient resource allocation, and it is hence important for the economic environment (Francis, Huang, Khurana, & Pereira, 2009).

#### ***2.4 The Audit Expectation Gap***

Gray, Turner, Coram and Mock (2011) argue that international standard setters are concerned about the content and usefulness of the audit reports. These concerns already occurred back in the early 1900s, and are referred to as an "expectation gap" or the "audit expectation gap". Schelluch & Gay (2006) refers to the audit

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expectation gap as "differences between the public's perceptions of the role and responsibilities of the auditor and the auditor's perception of these roles and responsibilities". They found significant differences between user's and auditor's perceptions of the auditor's responsibility and audit report messages related to prospective financial information (Schelluch & Gay, 2006). According to Porter (1993) the audit expectation gap has two major components: performance gap and reasonableness gap. The performance gap is defined as the gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve. Reasonableness gap is defined as the gap between what society expects auditors to achieve and what they can be reasonably expected to accomplish (Porter, 1993). Even though these two gaps almost look identical, they address different aspects. While the performance gap deals with an ideal, yet reasonable set of task, the reasonableness gap deals with the society's unreasonable expectations beyond the reasonable tasks (Gray et al., 2011). This indicates that the financial statement user, nor society at large, generally do not understand the auditor's responsibilities, duties or function (Porter, Ciaran, & Baskerville, 2009).

More easily explained, the expectation gap reflects the "difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is" (IAASB, 2011, p. 7). Asare and Wright (2012) argue that there are important differences between auditor's and user's perception of what is conveyed in an audit report. Their study showed that the users (investors and banks) had greater expectations of auditor's responsibilities. The users have, for instance, far greater confidence that the auditor has detected fraud than the auditors themselves, as well as greater confidence in the management of the entities. The arguments above illustrate the expectation gap's long lasting occurrence, and according to Gray et al. (2011), the gap is still prominent.

The communication gap is defined as a gap that "reflects differences between what users desire and understand, and what is communicated by the assurance provider" (Mock, et al., 2013). IAASB do not specifically define a communication gap, but it is reflected in the definition and discussion of the expectation gap. For instance, IAASB state that the use of standardized language or advanced terminology may

result in a gap between the users perception of what is done and what should be done in the audit (IAASB, 2011, p. 7). This is exactly what the communication gap sheds light upon (Simnett & Huggins, 2014).

Narrowing the audit expectation gap has been the main focus of previous changes to the audit report, however currently the main objective is narrowing the information gap (MARC, 2011). According to IAASB (2011), the information gap can be defined as “the existence of a gap between the information they (users) believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited financial statements or other publicly available information". The information gap increases the challenges related to the understanding of how financial statement information reflects the entity's financial performance (IAASB, 2011). This corresponds with Church et al.'s (2008) argument that the present report solely has a symbolic value. Carcello (2012) asserts that the standard audit report has a limited informational content, and this has been a concern to investors for years. He found that as much as 91 % of the respondents did not utilize the standard audit report in investment decisions, and 73 % only skimmed the report. He also found that 45 % of the respondents believed that the current report had no significant value (Carcello, 2012). The current report has been criticized for not communicating information relevant for investors, and the low interest for the report may stem from this discrepancy between what investors demand and what is communicated (Simnett & Huggins, 2014). The figure below illustrates the information gap.

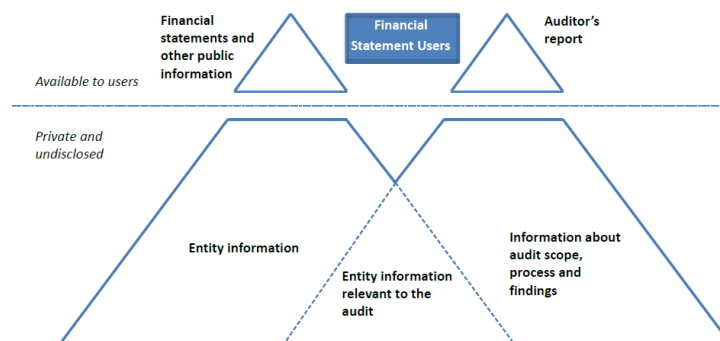


Figure 1 - Illustration of the information gap (IAASB 2011, p. 9)

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As seen in figure 1, the information gap occurs by the horizontal line dividing the top of the pyramid from the bottom. The information below the line is assumed to be non-public information. This means that the only information available for the financial statement user is reflected in the 'tip of the iceberg'. This information stems from various sources, including the audit report, the financial statements and other public information (IAASB, 2011).

According to IAASB (2011), the information gap could be narrowed by disclosing more information by the company management, those charged with governance or by the auditor. Changes of the structure and content could improve the communicative value of the report significantly (Simnett & Huggins, 2014). Carcello (2012) found that there is a demand for a change in the standard audit report, and that a discussion by the auditor of management's estimates and judgements would be favourable. IAASB (2011) also asserts that the auditor's insight into the entity and its business is interesting and relevant information for both investors and analysts. Adding credibility to the entity's financial statement will hence facilitate stakeholders' decision-making (Asare & Wright, 2012). Following the demand for a more entity specific and detailed auditor report, the new standard marks an important paradigm shift.

### ***2.5 Changes to the Auditor Report***

In the aftermath of the financial crisis in 2007, regulators and others have highlighted the limited value of the auditor's report and demanded significant changes (Knechel, 2009). Audit regulators and standard setters have responded by suggesting several improvements and sought out public comments to the audit report (Mock, et al., 2013). These suggestions are attempts to close the expectation-, communication- and information gaps.

In order to close the expectation gap, IAASB have suggested further clarity and information on different roles in the auditing process. Changes in communication and structure of the auditor report, as well as additional information about judgements made by the auditor is suggested as attempts to close the communication gap. This is what IAASB would call the communication problems

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related to the expectation gap. The main change suggested by IAASB is related to the information gap, in which additional information about the audit process and the entity being revised are suggested (Simnett & Huggins, 2014).

IAASB received positive feedback to the suggested changes, and according to Simnett & Huggins (2014), 74.4 % of the respondents agreed with the suggestions. IAASB continued the development of a new standard in cooperation with various auditors, policymakers and financial statement users, and in January 2015, they released the new standard related to the audit report (IAASB, 2015A). This standard is expected to be a 'game changer' for stakeholders by renewing the audit, with particularly focus on the communicative value (EY, 2016A).

The new standard for auditor's reporting, ISA 700 Revised, is in its final and approved form significantly different from the previous standard, ISA 700. As a result of IAASB's implementation of ISA 700 (Revised), the structure of the audit report is completely new. An overview of the differences between ISA 700 and ISA 700 (Revised) are presented below.

<b>ISA 700</b>	<b>Changes</b>
Introduction	Becomes part of the conclusion
Management responsibility	Moved to the end of the auditor's report
Auditors responsibility	Moved to the end of the auditor's report
Conclusion	Moved to the start of the auditor's report
Declaration according to laws and regulations	None

*Table 1 - Changes to ISA 700*

ISA 700 (Revised)	Comment
Conclusion	
The basis for the conclusion	New
Going concern, ISA 570	New
Key audit matters, ISA 701	New
Management responsibility	
Auditors responsibility	
Declaration according to laws and regulations	

Table 2 - Content of ISA 700 (Revised)

IAASB received numerous comments that the financial statement users preferred the conclusion presented earlier in the audit report (IAASB, 2013). Consequently, ISA 700 (Revised) presents the conclusion in the first part of the audit report. A new paragraph related to the conclusion is added, in which the auditor must explain the basis for the conclusion. In this paragraph, the auditor is supposed to give a description of the audit process, explain that he/she has followed international standards, and refer to the description of auditor's responsibility. The purpose is to increase the transparency of the auditor's work, and hence reduce the expectation gap (IAASB, 2015A). Several auditors agreed that they preferred the conclusion and a justification of the conclusion in the beginning of the audit report. The users of financial statements did too, and referred to the fact that there is usually limited time assigned to read the audit report (MARC, 2011). According to Simnett & Huggins (2014), the suggested structure of the audit report was supported by 72.5 % of the respondents, which illustrated the preferences for such a reform.

The financial crisis in 2007 was an important factor for the implementation of *Going Concern* (IAASB, 2012). Several users of financial statements believed that a clean audit report confirmed the financial health of a company (Gold, Gronewold, & Pott, 2012). However, this was evidently not always the case. Although the organization's annual reports were prepared on the assumption of going concern, and the auditor concluded that such an assumption was correct, certain unknown and unforeseen factors could ultimately lead to bankruptcy

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(Chen & Church, 1996). IAASB therefore determined that auditors should be required to issue a declaration whether, based on the audit, there has been identified material uncertainties regarding events or circumstances that may raise material doubt about the company's ability to continue operations. Research shows that users of the financial statements desire and value this type of information (Porter et al., 2009). However, auditors cannot predict all future events or conditions, so regardless of the quality or conclusion of the report; it is never a guarantee that the company's operations will continue (IAASB, 2015C).

ISA 570, Going Concern, has been effective since December 15<sup>th</sup> 2009 (IAASB, 2009B). There are no changes in the content regarding uncertainties related to going concern, but the discussion is no longer presented as supplementary information referring to the respective note in the financial statement. The discussion related to going concern is now presented as a separate section in the audit report with the heading *Material Uncertainty Related to Going Concern*. According to Marc (2011), this could increase the informative value of the audit report. By clearly explaining what is meant by the going concern assumption, the expectation gap can, according to Simnett & Huggins (2014), be reduced.

The third new paragraph is called Key Audit Matters, and represents the biggest change in the auditor's report (PwC, 2015). This is a new section, and unlike going concern, it has never been part of the information provided by the auditor before. The auditor must, for all listed companies, describe the essential conditions that were specifically emphasized in the audit, as well as the auditor's work related to this (Rafen, 2016). Setting the scope for such matters, a new standard called *ISA 701 – Communicating Key Audit Matters in the Independent Auditor's Report*, is released. As ISA 701 is the most essential part of this thesis, it will be discussed thoroughly in chapter 4.

Management's responsibilities shall be presented in the fourth paragraph. The organization's management prepare the financial statements, and are hence responsible for the accounts (Carcello, 2012). There are no major changes in the new audit report regarding management's responsibility. The paragraph is although elaborated, and requirements related to the description of management's



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responsibility has increased (IAASB, 2015A). As an extension of the implementation of going concern, the auditor must explicitly specify that the management is responsible for assessing the business to be a going concern (Simnett & Huggins, 2014). The management specifies whether the principle of going concern is relevant for the organization, and discloses the relevant factors in the assessment of the going concern assumption. A general description of the use of the going concern assumption, referring to ISA 570, is also presented. (IAASB, 2015A). The new requirements on management responsibility seeks toward a clearer statement of each relevant responsibility, as well as what these responsibilities specifically entails. This is essential in order to reduce the audit expectation gap (MARC, 2011). According to Simnett & Huggins (2014), 81.7 % of the respondents in their study agreed to the enhanced description of responsibility, as well as its placement in the auditor report.

The aim of the new audit report is to increase the transparency of auditor's work, entailing firm-specific information available for the public (Francis et al., 2009). The changes in the section about the auditor's responsibility is an attempt to reduce the expectation gap (Simnett & Huggins, 2014). IAASB has increased the requirements related to the description of the auditor's responsibility, that is, the section has been improved and become more specific. The purpose of such improvements is to clarify the auditor's responsibility for obtaining a high degree of assurance that the financial statements are free from material misstatements. However, a high degree of assurance is not an absolute guarantor that the financial statements are free from material misstatements (Knechel, 2009). This is important to communicate, as research has shown that users of financial statements believe that auditors present absolute, rather than, reasonable assurance for the financial statements (Gold et al., 2012). Such a definition or explanation must appear directly in the new audit report to ensure the user's understanding of what the concept of materiality covers (IAASB, 2015A). It is also possible to specify or describe the materiality level used in the audit, so that the user of the financial statements clearly understand what the auditor defines as a material misstatement (IAASB, 2015A). This will also contribute to benefits related to transparency and understanding regarding the audit and auditors work, as well as reducing the expectation gap (IAASB, 2012).

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The changes related to going concern is also important for the auditor's responsibilities, hence, the auditor shall conclude whether the management's use of the going concern assumption is appropriate. According to ISA 700 Revised, it must appear in the audit report how the auditor relates to a potential doubt about the company's ability to continue its operations. Including such in the audit report is, according to Menon and Williams (2010), highly relevant for the user of the financial statement.

## 3.0 The Reporting of Key Audit Matters

### 3.1 The Big Five Audit Firms

For decades, a few major firms have dominated the audit industry. As of today, 'big four' audit firms dominate the audit industry internationally. The big four audit firms consist of Deloitte, EY, KPMG and PwC. In 2016, their combined revenue amounted to \$ 128 billion. All of the big four audit firms have offices in more than 150 countries, and in total approximately 887 800 employees all around the world (Accountingverse, 2017).

Originally, the big four audit firms dominated the Norwegian audit industry as well. However, through a number of successful mergers and acquisitions in recent years, BDO has become an audit giant in line with the four other major audit firms. In Norway, it is common to refer to the biggest audit firms as the 'big five', which includes BDO. In total, the big five audit firms' revenues amounted to NOK 9.8 billion in the fiscal year 2015/2016 in Norway.

As of 2016, EY was the biggest audit firm in Norway in terms of revenue, and BDO was the smallest<sup>3</sup>.



Figure 2 - Total revenue for each of the big five audit firms (MNOK)

<sup>3</sup> The numbers are derived from the big five audit firm's transparency reports

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The big five audit firms have different clients' accounts; however, they are present in several of the same industry sectors. For instance, all the big five audit firms are present in trade and industry, energy, financial services, the public sector and technology, media and telecom.

The big five audit firms are recognized for having resources and expertise to assist in ensuring adequate quality in reporting to the capital market (Deloitte, 2017). Increased complexity in financial reporting and other reporting requirements may be reasons why the big five audit firms handle the vast majority of the companies on the Norwegian stock exchange. The reporting of Key Audit Matters is mandatory for listed companies in Norway and the big five audit firms are presumed the primary group of auditors subject to ISA 701 (KAM).

### ***3.2 The Objective of Implementing Key Audit Matters***

According to ISA 701, the auditor should determine the key audit matters, and communicate those in the audit report. The objective of the standard is to add communicative value to the audit report by providing greater transparency of the audit process, and hence reduce the information gap (IAASB, 2015B).

The communication of KAM is intended to provide relevant information helping the users of financial statements to get a better understanding of the entity and areas of significant auditor judgement. By communicating the key aspects of the audit, the audit report becomes more concrete and entity specific (Deloitte, 2016A). Research by both Church et al. (2008) and Porter et al. (2009) shows that the users of financial statements value entity specific information. According to Cardos and Fülöp (2015), 66 % of the respondents of IAASB's exposure drafts agrees with the proposals, and believe that this will contribute to improved informational value for the user. Den norske Revisorforening (DnR), expressed in their commentary on the Exposure Drafts that they believe the reporting on KAM will give additional useful information to the users of the audit report (DnR, 2013). Terry, Mock, Coram and Gray (2010) argue that the information which auditors collect during the audit is proved valuable for the users, and especially information related to the entity's risk and viability. According to Smith (2016),

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the communicative value and usefulness of the audit report will increase, as KAM becomes a part of the audit report.

Although the implementation of KAM has significantly changed the audit report, it is not supposed to affect the auditor's conclusion or management's work. KAM should not be seen as a separate opinion or conclusion, nor a substitute for the management's information in the annual report. It is not a substitute for the auditors expressing a modified opinion when required (ISA 705) or a substitute for the information related to going concern (ISA 570) (IAASB, 2015B). The description of KAM should be regarded as purely informative, with the purpose of providing the user with relevant information (EY, 2016A).

### ***3.3 Identification of Key Audit Matters***

Besides the description in the above section on when and why key aspects of the audit should be included in the audit report, it is relevant to look into the definition of a key audit matter. According to IAASB, KAM is defined as follows:

*"Key audit matters are defined as those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance" (IAASB, 2015B).*

The definition specifies several attributes of a key audit matter. First the auditor's professional judgement is important in assessing whether a condition should be classified a key aspect of the audit. This is often based on the audited company's own key judgements. Further, in order to be classified as a key aspect, the condition must be of greatest importance to the audit in the current period, and finally, it is important that the key aspects are communicated with those charged with governance. This means that key audit matters, or the key aspects of the audit, are characterized as conditions that, according to the auditor, have the greatest impact in the process of auditing (Gutierrez, Minutti-Meza, Tatum, & Vulcheva, 2016). The judgement-based decision-making framework in ISA 701 is

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designed for the auditor to select a smaller number of matters, which all are of particular significance in the audit. Those matters are the KAMs (Kuan, 2016).

ISA 701, paragraph 9 and 10, describes in detail how the key audit matters should be selected. The selection can be divided into three levels, which is illustrated in the figure below.



Figure 3 - Key Audit Matters (KPMG, 2015A)

The first level includes all aspects that are communicated to those charged with governance. In practice, the auditor may communicate several conditions that do not require considerable attention from the auditor in the audit process (PwC, 2015). Hence, not all conditions communicated will be included as KAMs in the audit report (Rafen, 2016). Conditions that are communicated to those charged with governance should be of *higher risk*, i.e. areas which the auditor believes are of greatest likelihood of having material misstatements. As explained in chapter 2.2, the auditor performs risk assessments of a client even before contracts are signed, and this process continues in the planning phase of the audit. This implies that the auditor may have expectations on what will be identified as a higher risk at an early stage. However, in the planning phase of the audit, identifying KAM is not of importance – the auditor should focus on performing a wide risk assessment, and as a result of this, the auditor will be able to identify which aspects should be communicated to those charged with governance.

Among those matters that are communicated to the management, the auditor is supposed to highlight the matters that have required extra attention (Christensen, Glover, & Wolfe, 2014). There are several conditions that could be of importance,

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such as areas with higher risk of material misstatement or significant errors areas where critical judgment are necessary, including significant accounting estimates, and areas where significant events or transactions has an impact on the audit (Kuan, 2016). The auditor assesses the same aspects when determining which risks are of most significance (DnR, 2017, p. 225). This implies that level two in the figure may represent significant risks, and what the auditor defines as a significant risk may ultimately end up being classified a key audit matter.

It is up to the auditor to decide which factors are of *most* significance in the audit of the financial statements in the current period. The factors chosen must be included in the section about KAM (IAASB, 2015B). The assessment of what is classified a KAM can be situational and highly demanding (Rafen, 2016). In accordance with IFRS, the entity itself discloses the most discretionary areas when preparing the financial statements (Carcello, 2012), and those are often called the company's key judgements. There are reasons to believe that several KAMs presented in the auditor's report will be similar to the key judgements presented by the entity itself, although they are built on different assessments. In assessing the KAMs, the auditor would consider the importance of the key aspect for the user's understanding of the financial statement as a whole, and the complexity or subjectivity of management's choice of accounting policy compared with industry practice. The auditor would also consider the difficulty in performing audit procedure, the degree of discretionary and the results, including any identified control deficiencies. The nature and number of key audit matters will hence depend on the industry, the company, and the risks and challenges the company is facing (Rafen, 2016).

It is not of IAASB's interest to set a number of minimum conditions that must be communicated in the report, nor do they intend to limit the number of conditions that can be communicated. In certain cases, the auditor may conclude that there are no key audit matters to communicate in the audit report. This is, however, believed to be a rare occurrence (PwC, 2015). In other cases, the auditor may include numerous conditions. However, IAASB (2015B) states that a long list of conditions most likely will reduce the effectiveness of the auditor's communication of KAM and hence decrease the communicative value. The

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auditor is intended to choose a number of conditions that fit the nature, size and complexity of the company (Rafen, 2016). Experiences from the UK shows that the number of conditions differ between industries, auditors and the size of the company (FRC, 2015).

### ***3.4 Communicating Key Audit Matter***

The audit report will be supplied with a substantial section as the new standard, ISA 701, is implemented. After identifying the key aspects of the audit, the auditor will communicate those under the new section *Key Audit Matters*. In this section, the auditor should define and introduce the key audit matters, and divide each KAM into a subsection. In each of these subsections, the auditor is supposed to describe the key audit matter in detail, with the following requirements (IAASB, 2015B).

1. Describe why the condition is selected as a key audit matter, and thus considered to be one of the conditions in the audit of most significance
2. Describe how the specific aspects were addressed in the audit
3. Provide a reference to any related disclosure in the financial statement concerning the key aspect

In order to improve the communicative value of the audit report, IAASB emphasizes the importance of a detailed description of the relevant KAMs. According to the standard, there are only two circumstances under which a matter determined to be KAM is not required to be communicated in the audit report (IAASB, 2015B). The first is where law or regulation precludes public disclosure about the matter. The second is under extremely rare circumstances, where the auditor determines that the possible consequence of the disclosure would be expected to outweigh the public interest or benefit of the communication (PwC, 2015). However, it should be expressed under the section of key audit matters, if the auditor did not find any key aspects of the audit. When the auditor finds key audit matters, which are communicated either by modifying the conclusion, or uncertainties related to going concern, the auditor should refer to the section where the conditions are described (IAASB, 2015B).



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The importance of a clear language emerges with ISA 701. In order to improve the communicative value of the audit report, it is important that the reader understands and interprets correctly. For the users to understand, the auditor has to describe KAMs in a clear and specific manner, and avoid advanced terminology (EY, 2016A). It is essential that the description of KAM is adapted to the actual circumstances, and that standard formulations and boilerplate language is minimized (MARC, 2011). Rafen (2016) explains that the new audit report will entail extra work with listings and linguistic formulations. The formulations should not be too standardized, nor be too advanced. This will be a complex and time intensive process, particularly in Norway where several companies have accounts in both English and Norwegian language (Rafen, 2016). ISA 701 will also require more dialogue, discussions and close cooperation with the management, the audit committee and the board. For the intended users to understand the importance of central aspects of the audit, it is necessary to exercise caution so that the layout is not standardized with general formulations or gives the impression of sub-conclusions about individual topics in the financial statements (IAASB, 2013). IAASB note that the way in which auditors communicate, including the use of boilerplate language, can leave users with confusions on what is actually done and concluded in the audit (IAASB, 2015B). Czerney, Schmidt and Thompson (2014) suggest that the new standard, with more explanatory language, may have an attention directing effect among investors. According to Reid (2015) this will provide investors with useful information, and hence reduce the information gap. With more readable reports, the investors will be provided with information that enables them to make well-founded investment decisions (Smith, 2016). Smith further claims that the extended audit reports in UK are much more readable, compared to the standard audit reports, and emphasizes its increased communicative value.

### ***3.5 Experiences of KAM from the United Kingdom***

The UK have had expanded requirements related to the audit report since 2013. The UK audit reports have attracted considerable international attention, and investors have appreciated the insight and usefulness of the extended audit report (KPMG, 2015B). Impressions of other standards similar to ISA 701, such as the

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extended report in UK, are relevant to investigate in order to understand the potential impact of ISA 701 in Norway (PwC, 2015). Financial Reporting Council (FRC) has developed a report containing a thorough examination of 153 UK audit reports from the first year of the implementation of key audit matters (FRC, 2015). According to Simnett & Huggins (2014), there is a global desire to converge audit standards and processes, and thus there are reasons to believe that Norwegian audit reports will resemble the first year reports in the UK. The findings compiled by FRC are expected to be relevant and comparable to the audit reports published in Norway during the spring of 2017.

Reactions to the new audit report in UK have mainly been positive, indicating that the expansion of audit reports represent a major step forward (PwC, 2015). In the UK, the Investment Management Association (IMA) annually arranges an Auditor Reporting Award, where the best audit reports receive eminent prizes. The IMA award is publicly recognized for providing clear signals on what the users of financial statements deem useful in the audit reports. Subsequent to the first year of KAM-reporting in the UK, the IMA judges appointed certain relevant factors in the evaluation of each audit report. They especially appreciated when the auditor included entity specific KAMs, and when standard risks, applicable for all firms, were excluded. 'How the matter was addressed in the audit' ('Audit Response') was also considered a highly important element of the expanded audit report. The judges awarded reports where the auditor discussed their audit procedures in detail. In the UK, several auditors used headlines and tabular presentations. Although specific layout is not a requirement of the extended audit report, the judges preferred reports that had engaging layouts.

Materiality was another important factor enhanced in UK reports. However, as the audit standard in UK has extended requirements related to this, and ISA 701 does not, the thesis will not focus on materiality.

### *3.5.1 Key Audit Matters Reported*

Experiences from the UK show that the number and type of KAMs differ between industries, auditors and the size of the audited company (FRC, 2015). Although

several differences regarding number and type of KAMs reported exist, certain key audit matters recurred in the UK audit reports.

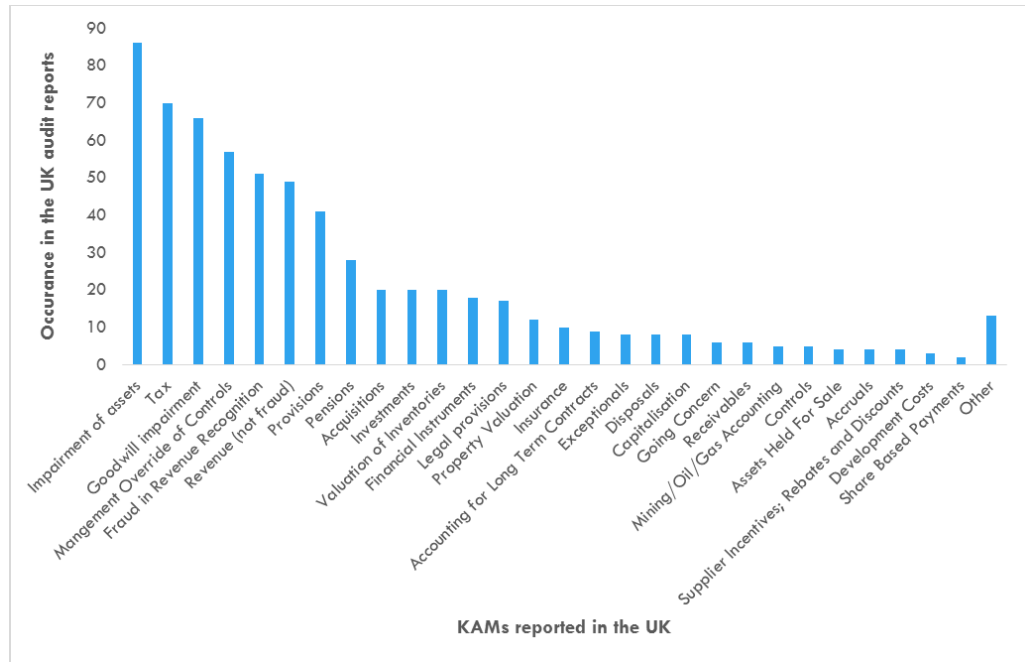


Figure 4 - The occurrence of each KAM reported in UK audit reports (FRC, 2015)

The five most frequently reported KAMs in the first-year UK audit reports were as follows:

1. Impairment of Assets
2. Tax
3. Goodwill Impairment
4. The risk of management override of controls
5. The risk of fraud in revenue recognition

'Impairment of assets' was included in as much as 56 % of the analysed reports, and was thus the most frequently reported KAM in the UK audit reports. 'Tax' was included in 46 % of the UK audit reports, and 'goodwill impairment' was included in 43 % respectively (FRC, 2015). According to Rafen (2016), the 'risk of fraud in revenue recognition' and 'risk of management override of controls' are both aspects in which the auditor always considers a risk in the audit, and thus a "standard condition" which per definition should not be included as a KAM.

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To illustrate the widespread use of standard KAMs in the UK reports, FRC showed that the average number of KAMs were affected considerably when removing standard KAMs from the analysis. The overall average number of key audit matters reported was 4.2, where PwC at 4.9 was the only company above average. When removing standard KAMs from the analysis, the average number of KAMs was reduced to 3.5, and PwC at 2.9 was alone in being below the average. Since removing standard KAMs from the analysis affects the average number of reported KAMs considerably, this indicates how large an impact standard KAMs have on the analysis. As standard KAMs often apply to all companies and hence do not provide increased entity specific information (Rafen, 2016), standard KAMs provide low communicative value for the financial statement user.

An interesting approach when investigating the differences in the reporting of key audit matters between the Norwegian big five audit firms is analysing the number and type of key audit matters. It is reasonable to expect similar tendencies as in the UK, and the following research question will be investigated in Norwegian audit reports as of December 15<sup>th</sup> 2016:

- 1. To which extent will the big five audit firms include 'impairment of assets', 'tax' and 'goodwill impairment' as the most frequent key audit matters?***

### *3.5.2 The Description of Key Audit Matters*

Standardized descriptions of key audit matters are discovered in UK audit reports. This indicates that the KAM is described in generic terms, not linking the information directly to the entity. In order to provide a better understanding of the audited entity, it is important that the auditor describes their selected KAMs in a granular manner, and avoids standard explanations (Rafen, 2016). The auditing standard encourages auditors to be entity specific. This implies that the auditor should provide explanations that can be related directly to the specific circumstances of the audited entity. This is expected to give a better understanding

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than using a generic or abstract explanation expressed in standardized language (FRC, 2015).

Findings from the UK show that 61 % of all the analysed conditions were written in a granular and entity-specific manner. Several of the audit reports regarded as most granular have received positive publicity. PwC's audit report on Smiths Group Plc's has been praised for quantifying the value of the risks, making the information more specific and comprehensible. Its structured format and clear KAM descriptions made it the winner of the Financial Times Stock Exchange (FTSE) 100 most innovative report (FRC, 2015). The audit report on JD Wetherspoon Plc, also audited by PwC, has been recognized for its unique and detailed description of the key aspects. Rathbone Brothers Plc's audit report, issued by KPMG, was detailed, yet articulated in a simple manner and contained an easily understandable section of the description of the key audit matters.

Although several audit reports meet the standard's requirements in terms of granular descriptions, other reports seem to have various shortcomings in the descriptions of KAMs. According to the FRC (2015), 39 % of all the descriptions of KAMs were generic. Excluding KPMG from the analysis increased the proportion of generic conditions, in which 50 % of the conditions were categorized as generic. This illustrates the differences in the audit firm's descriptions of KAMs.

An interesting approach when investigating the differences in the reporting of key audit matters between the Norwegian big five audit firms is analysing the description of key audit matters. It is reasonable to expect similar tendencies as in the UK, and the following research question will be investigated in Norwegian audit reports as of December 15<sup>th</sup> 2016:

***2. To which extent will the description of key audit matters differ in granularity between the big five audit firms?***

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### *3.5.3 The Description of 'How the Matter was Addressed in the Audit'*

In addition to the identification and description of each key audit matter, the auditor should explain their audit procedures in the process of detecting the key audit matters. This is referred to as 'how the matter was addressed in the audit' or 'Audit Response'. The expanded report in UK requires that the description of 'how the matter was addressed in the audit' is directly related to the specific circumstances of the audited entity and are not generic or abstract matters (FRC, 2015). The discussion on 'how the matter was addressed in the audit' can contribute to a better understanding of the auditor's work (Rafen, 2016). According to PwC, several investors found the descriptions of 'how the matter was addressed in the audit' incomplete since the auditor did not go further to describe the findings or outcome. The investors did not want a list of procedures; they wanted to know how the auditor responded to them with their audit procedures, as well as the audit findings (PwC, 2015).

FRC found that 56 % of the reports from the first year in UK provided a comprehensible and detailed explanation of 'how the matter was addressed in the audit'. 24 % of the reports seemed to meet the requirement more in form than in substance (i.e. giving no valuable information, only listing the minimum of information required), and 20 % did not fully meet the requirements. This underlines the differences between the reports. The FRC also highlight the variations by presenting several reports that have received either positive or negative feedback.

KPMG delivered the audit report on Rolls Royce Holdings Plc, which apparently met the expectations for 'how the matter was addressed in the audit' in terms of order, information and number of different measures described. The audit report provided significant insight into the audit process and the issues that the auditor had to consider (FRC, 2015). Under the assessment of risks of material misstatement, the auditor outlined the risk, described how the matter was addressed in detail and in an informative manner; described what they found. The inclusion of findings was a step further than other audit reports and provided a real added value, giving colour as to whether management's judgements were balanced, mildly optimistic or mildly pessimistic in the view of the auditor. In

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addition, KPMG tested a model for reporting how the matter was addressed, which included additional explanations on how the engagement partner made his risk assessment and how it affected the audit procedures. This was positively received by many readers (FRC, 2015). EY's audit report on the Weir Group provided further variation in addition to comparative information and has been included in FRC's report as a good example on the section 'how the matter was addressed in the audit'.

Although several audit reports have received positive public attention on their granular descriptions of 'how the matter was addressed in the audit', other reports provide rather generic descriptions of this section. A generic description of 'how the matter was addressed in the audit' will provide no relevant information to the reader, since in this context, the relevance of information depend on entity specific information (Asare & Wright, 2012).

There are large differences in the descriptions of 'how the matter was addressed in the audit' between audit firms in UK. An interesting approach when investigating the differences in the reporting of key audit matters between the Norwegian big five audit firms is analysing the description of 'how the matter was addressed in the audit'. It is reasonable to expect similar tendencies as in the UK, and the following research question will be investigated in Norwegian audit reports as of December 15<sup>th</sup> 2016:

***3. To which extent will the description of 'how the matter was addressed in the audit' differ in granularity between the big five audit firms?***

*3.5.4 The Use of Advanced Language in the KAM Section*

Besides the description of the key audit matters-, and 'how the matter was addressed in the audit', the language is an important aspect of the new standard ISA 701. The implementation of key audit matters entails increased information included in the audit report. For the users to interpret the information correctly, the auditor has to avoid advanced terminology (EY, 2016A). IAASB note that the way in which auditors communicate, including the use of advanced language, can

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leave users with confusion regarding what is actually conducted in the audit (IAASB, 2015B)

The IMA Auditor Reporting Awards in UK distributed some of their most eminent prizes to selected audit reports, based on language. Smiths Group Plc's audit report was recognized for its easily comprehensible language (FRC, 2015), becoming the winner of the FTSE 100 most innovative report. The audit report from JD Wetherspoon Plc was praised for its simple language and for having an informative overview on the first page, providing a unique description of the key audit matters.

Not all UK audit reports have been recognized for its choice of wording, and advanced terminology can prevent the understanding of tidings in the audit report. PwC explains that a challenge in the UK has been to draft succinct key audit matters addressing the aspects of the audit, in language understandable to the reader (PwC, 2014). What is perceived as 'understandable' will differ from reader to reader, however, suitable language can contribute to a more common understanding on the topics addressed in the audit report.

An interesting approach when investigating the differences in the reporting of key audit matters in Norwegian audit reports is analysing the percentage of audit reports with advanced language. It is reasonable to expect similar tendencies as in the UK, and the following research question will be investigated in Norwegian audit reports as of December 15<sup>th</sup> 2016:

***4. To which extent will the level of advanced language in the key audit matter- section differ between the big five audit firms?***

*3.5.5 The Presentation Format of the KAM Section*

The presentation of the KAM section in the audit report has been of importance in the UK. The IMA Auditor Reporting Awards in UK highlighted characteristics related to the presentation of KAM that recurred in most of the winning audit reports. Special design, colours, tabular presentations and the use of graphs and



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charts were some of the characteristics. The extended audit report is supposed to be more structured and straightforward, while at the same time providing more extensive information to the reader. The use of tabular presentations with graphs and charts is assumed to help to achieve both. The audit reports identified as 'best practice' examples by both auditors and investors, were clearly designed to have a visual appeal and they included a large number of diagrams (FRC, 2015).

The big four audit firms in UK (Deloitte, EY, KPMG and PwC) have taken the opportunity to improve the communication in the audit reports by using special design, colours or tabular presentations (FRC, 2015). A particular technique has been the use of tabular presentation, linking the description of each KAM and the explanation of 'how the matter was addressed in the audit'. Deloitte's audit report on Petropavlovsk Plc won the award for 'Innovation', for its engaging layout as well as its diligent use of tables and charts. PwC's report on Cairn Energy Plc has been recognized for its transparent table illustrating the key audit matters. The perhaps most extensive use of diagrams was in KPMG's audit report on Astra Zenaca which provided informative diagrams on the materiality of the Group Financial Statements (FRC, 2015). In order to provide a map for other relevant sections of the annual report, some of the reports included relevant cross references to for instance the Audit Committee Report and the Financial Review in addition to the financial statements (FRC, 2015). This is expected to increase the understanding, and hence communicative value for the intended user.

As The IMA Auditor Reporting Awards highlighted the use of special design, colours and tabular presentations in audit reports in UK (FRC, 2015), an interesting approach when investigating the differences in the reporting of key audit matters in Norwegian audit reports is analysing the presentation format of the section key audit matters. It is reasonable to expect similar tendencies as in the UK, and the following research question will be investigated in Norwegian audit reports as of December 15<sup>th</sup> 2016:

***5. To which extent will the presentation format of the key audit matter-section differ between the big five audit firms?***

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### ***3.6 Research Questions***

The objective of this master thesis is to examine the differences in the reporting practices of key audit matters between the big five audit firms in Norway. With the purpose of finding such answers, five research questions have been derived. They are as follows:

- 1. To which extent will the big five audit firms include 'impairment of assets', 'tax' and 'goodwill impairment' as the most frequent key audit matters?***
- 2. To which extent will the description of key audit matters differ in granularity between the big five audit firms?***
- 3. To which extent will the description of 'how the matter was addressed in the audit' differ in granularity between the big five audit firms?***
- 4. To which extent will the level of advanced language in the key audit matter- section differ between the big five audit firms?***
- 5. To which extent will the presentation format of the key audit matter- section differ between the big five audit firms?***

The following chapter *Research Design and Method* comprises a thorough explanation of how the selected research questions will be examined.

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## 4.0 Research Design and Method

### *4.1 Combinational Study*

In methodological issues, research mainly distinguishes between qualitative and quantitative methods of investigation. This study will review, analyse and collect data on key audit matters from published Norwegian audit reports as of December 15<sup>th</sup> 2016. The combinational study consist of both quantitative and qualitative data. Quantitative methods focus on measurement, i.e. numerical sizes or specific words that can be measured directly (Zikmund, Babin, Carr, & Griffin, 2013). Qualitative methods are mainly used to study social phenomena (Jacobsen, 2015). A qualitative method provides descriptions in text rather than measurements (Ringdal, 2007). The objective of this thesis is to investigate the differences in the reporting practices of key audit matters in Norwegian audit reports. The study will map the implementation of KAM in Norway, and identify differences and similarities among the big five. The problem statement will be approached by a combinational study, with both quantitative and qualitative data collections.

Industry, audit firm and number of key audit matters are examples of elements that comprise numerical sizes and specific words. The data will be assembled appropriately to be able to compare, evaluate and conclude on the output.

The evaluation of the descriptions of the key audit matters and 'how the matter was addressed in the audit' ('Audit Response'), as well as an evaluation of the language and presentation format, are aspects that require subjective assessment. This represents the qualitative part of the data collection. Different criteria are utilized to assess whether a report contains satisfactory descriptions or not. Those criteria include the level of detail, the inclusion of company-specific information, explanations on the background for the assessments, explanations on consequences, and events related to FY 2016. Based on this, each report has received a score for each analysed part of the report. The analysed parts are the description of the key audit matter and the description of 'how the matter was addressed in the audit'.

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Each section has been assessed 'satisfactory', 'unsatisfactory' or 'neither'. The assessments are based on discretionary impressions of the totality of the section. The assessment 'satisfactory', however, require that most of the relevant criteria mentioned above are fulfilled, while the assessment 'unsatisfactory' indicate that most of the criteria mentioned above are missing or incomplete. The descriptions placed in the 'neither'-category either contain audit reports that deliver different descriptions of the KAMs, for instance one granular KAM whilst the others are more generic, or descriptions that are relevant and entity-specific, yet some important aspects are missing, such as reference specifically related to FY 2016. The audit reports containing zero KAMs have not received a score related to the description of KAM or the description of 'how the matter was addressed in the audit'.

The purpose of this data collection is to investigate the differences in the reporting of key audit matters between the big five audit firms and elements collected from both the quantitative and qualitative analysis are of importance for this purpose.

The quantitative and qualitative data will be systematized in a suitable structured Excel file, and will subsequently be analysed in a descriptive way. The findings will be presented with the use of the quantitative method, which is descriptive statistics. Descriptive statistics are most commonly used in quantitative methodology (Melvær, 2014). According to Saunders, Lewis and Thornhill (2012), the objective of descriptive statistics is to gain an accurate profile of events, persons or situations. Quantitative analysis techniques will be utilized, such as tables and charts, to better explore, present, describe and examine the findings (Saunders, Lewis, & Thornhill, 2012). Certain quantitative analyses are supplemented by regression analyses in cases where this provides more reliable results.

The sample selection consists of audit reports of Norwegian companies that are listed at Oslo Stock Exchange (*Oslo Børs* or *Oslo Axxess*). Oslo Børs and Oslo Axxess are chosen because the new standard is mandatory for all listed companies. The focus is narrowed to audit reports prepared by Norwegian auditors, as there might be small differences between countries. For instance, the Netherlands, UK

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and France introduced an extended report years before ISA 700 Revised and ISA 701 was released in Norway, and comparing these to the audit reports as of December 15<sup>th</sup> 2016 in Norway might bias the results.

The sample selection is further narrowed to the auditor reports that are published no later than April 30<sup>th</sup> 2017. The majority of the Norwegian audit reports are published within this date, and the selection of published reports is thus considered sufficiently large. Another relevant factor to this narrowing is the desire to publish the results of this thesis before the summer, to make the findings pioneers in Norwegian literature. However, excluding audit reports published after April 30<sup>th</sup> 2017 can potentially bias the results.

The sample of this study consists of 139 audit reports issued by different audit firms in Norway. The big five issued the largest proportion of these audit reports, while only two were issued by other audit firms. As this study examines the differences in the reporting of key audit matters between the big five audit firms, audit reports issued by other audit firms will be excluded. Hence, the sample of this study consists of 137 audit reports issued by the big five audit firms.

#### ***4.2 Qualitative Methodology, Supporting the Combinational Study***

The combinational study will be complemented by qualitative interviews, with the purpose of finding underlying reasons for the differences. According to Ringdal (2007), the most common method of qualitative data collection is through interviews. By complementing the combinational research with a qualitative method, a better basis is provided for understanding the output derived from the combinational analysis. The interviews have a supporting role in this study. Both methods are expected to add relevant value to this thesis.

In order to obtain relevant knowledge on the differences in reporting key audit matters between the big five audit firms, the auditor's professional judgement is central. A qualitative method investigating how the auditor has used his professional judgement in the audit is therefore interesting. By investigating the different aspects of the auditor's professional judgement, it is possible to seek

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answers to why there exists differences between audit reports in terms of the number and type of key audit matters, the description of KAM, 'how the matter was addressed', language and how the section of KAM is presented. This will be important for the analysis on how the reporting of key audit matters differs between the Norwegian big five audit firms.

When adapting a qualitative method, it is possible to taper the collected information. After the information is collected, it will be structured, categorized and compared. Hence, all the relevant information for this particular study will be exploited (Jacobsen, 2015). The chosen method of data collection is semi-structured in-depth interviews. Such interviews imply that the themes and questions are determined in advance, however it enables respondents to answer freely. This is a flexible and natural approach of interviewing, which also gives the opportunity to clarify and ask follow-up questions (Bryman & Bell, 2015). It allows for asking questions in a way that is adapted to the respondents' answers to previous questions, and to ask for more in-depth answers (Zikmund, Babin, Carr, & Griffin, 2013). The respondent's body language and facial expressions are also observable, which may give a better understanding of the respondent and his/hers answers. However, in a dialogue, both the interviewer and the respondent are influenced by each other. For instance, the order of the questions can affect the corresponding answers. There is also a possibility that the respondent's facial expressions and body language are perceived incorrectly, which may cause uncertainty related to the interpretation of their answers.

The sample selection related to the interviews consist of certified public accountants (CPAs) from the big five audit firms in Norway (BDO, Deloitte, EY, KPMG and PwC). These audit firms handle the majority of the larger entities on the Norwegian stock market, and are therefore a natural choice of selection. ISA 701 is mandatory for listed companies and the big five audit firms are in that sense the primary group of auditors. The sample size of this study is selected to consist of one or two auditors from the five different audit firms. With the exception of EY, each selected respondent has had a central role in the implementation of KAM in its specific audit company. This study comprises five different in-depth interviews with certified public accountants from the big five audit firms.

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Johannessen, Kristoffersen and Tufte (2011) claim that five to ten in-depth interviews are appropriate if time and resources are limited. However, the validity and reliability of the findings can be questioned with a limited sample of respondents. Chapter 6.1 of this thesis obtains a further discussion on limitations.

Considering the breadth and the diversity of auditors, it will not be possible to select unbiased or random subsets of individuals. This research does not intend to be an accurate representation of its population; interviewing a selection of relevant individuals will be satisfactory in this case.

Respondent	Company	Professional Title	Years of Audit Experience
Respondent A	EY	Partner	23
Respondent B	KPMG	Partner	23
Respondent C	KPMG	Director	15
Respondent D	PwC	Director	27
Respondent E	Deloitte	Partner	47
Respondent F	Deloitte	Partner	28
Respondent G	BDO	Partner	31

*Table 3 - List of respondents*

The interviews are structured in two parts. First, general questions regarding impressions of the former audit standard, as well as expectations for the new audit standard are introduced, mainly to trigger interest in the topic. Second, respondents receive information about the findings from the combinational part of the analysis. The respondents are asked to comment on the findings and explain the background to the results to the extent that they find this possible. In order to get the most authentic answers, the respondents are suggested to explain their version before receiving specific information about findings. No constraints on the responses were presented.

The structure of the analysis- section in this thesis will be a compilation of both the combinational study and the qualitative method. First, a presentation of the findings from the data collection is derived, followed by supplementary comments and suggestions retrieved through the interviews.

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## 5.0 Empirical Findings

The sample of this study consists of 137 audit reports issued by the big five audit firms in Norway. The table below presents the distribution of audit reports included in this sample. EY is the largest audit company in Norway and represent thus the biggest proportion of the reports. They issued 39 % of the audit reports in this analysis, followed by PwC, which counts for 20 % of the analysed audit reports. KPMG, Deloitte and BDO issued respectively 15 %, 14 % and 12 % of the 137 audit reports in this sample.

Auditor	Share of audit reports
BDO	12 %
Deloitte	14 %
EY	39 %
KPMG	15 %
PwC	20 %
Total	100 %

*Table 4 - Share of audit reports by each audit firm*

Table 5 (below) provides an overview of each audit company's presence in the different main sectors. 'Bank and financial services' is the largest industry in this analysis and amounts for 24 % of the total number of audit reports. All the big five audit firms are present in the financial industry, however, PwC is present to the greatest extent. Two main factors may explain why the financial industry is widespread in our sample. First of all: 'bank and financial services' is a wide industry, including all types of banks- and economic services provided by the finance industry. Second of all: 'bank and financial services' tend to operate with an early deadline for publishing annual reports meaning that the largest proportion of Norwegian reports within this industry are included in the analysis.



Industry	BDO	Deloitte	EY	KPMG	PwC
Banks and financial services	12 %	21 %	21 %	15 %	30 %
Consulting			67 %		33 %
Health care	20 %		60 %	20 %	
Industrial	18 %	6 %	29 %	35 %	12 %
IT and telecom	23 %	15 %	62 %		
Natural resources		17 %	33 %	17 %	33 %
Oil and gas		6 %	53 %	12 %	29 %
Publishing and broadcasting	25 %	25 %	25 %		25 %
Real estate	29 %	14 %	29 %		29 %
Retail	20 %	20 %	20 %		40 %
Transportation & Logistics		19 %	56 %	19 %	6 %

Table 5 - Percentage of audit reports in each industry

Not surprisingly, the industry sector 'oil and gas' is well represented in the Norwegian stock market. BDO is the only audit company absent in this industry. EY is alone in being present in all of the industry sectors included in this analysis. A further discussion related to this sector will be presented in chapter 5.2.

### 5.1 The Number of Key Audit Matters Reported

There are differences in the number of key audit matters reported by each audit company. Table 6 displays the highest, the lowest and the average number of key audit matters reported. The number of KAMs reported in Norwegian audit reports ranks from zero to five, where EY is the only audit company reporting zero- and KPMG is the only reporting five key audit matters in selected audit reports.

Auditor	Highest no. of KAMs reported	Lowest no. of KAMs reported	Average no. of KAMs reported
BDO	4	1	2,38
Deloitte	4	1	2,63
EY	4	0	1,59
KPMG	5	1	2,75
PwC	3	1	2,03
<b>Total</b>	<b>5</b>	<b>0</b>	<b>2,28</b>

Table 6 - The highest, the lowest and the average number of key audit matters reported, shown in actual numbers

The total average of KAMs reported is 2.28, where EY and PwC are below the average, while BDO, Deloitte and KPMG are above. KPMG report on average 2.75 key audit matters, which is the highest average number of KAMs among the big five audit firms. EY report on average 1.59 key audit matters, which is the lowest average number of KAMs among the audit firms. The figure below presents the distribution of key audit matters reported by each audit company. The analysis shows the KAMs frequency relative to each audit company.

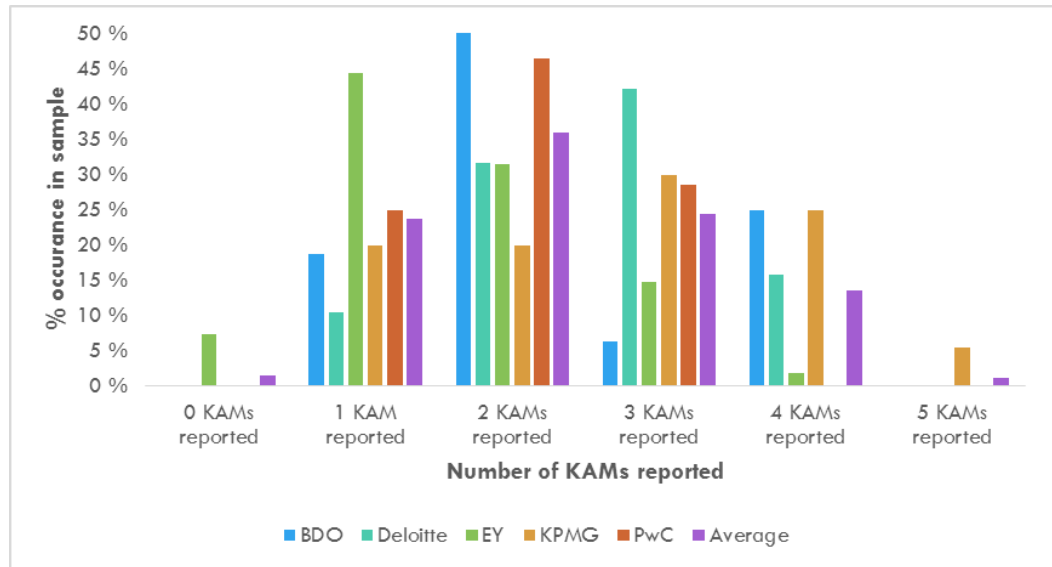


Figure 5 - The frequency of number of KAMs reported, shown in percentage

There are differences in the proportion of key audit matters reported. However, some systematic tendencies are discovered within each audit company. For instance, BDO and PwC report two KAMs in respectively 50 % and 46 % of the audit reports in this sample. Two key audit matters is the most frequent number of KAMs reported on average, which amounts to 37 % of the audit reports. However, in 42 % of Deloitte's audit reports and 30 % of KPMG's audit reports, three key audit matters is most widespread. EY report one single key audit matter in 44 % of the sampled audit reports. The respondent from EY explain through the interview that the number of KAMs is not a coincidence. They have been explicitly concerned with the definition of what is a key audit matter. The respondents state that it has not been an aim for EY to deliver audit reports with a high number of key audit matters. For them, the most important has been to identify what is *key*, rather than what is an *audit matter*. The respondents from

KPMG explain that, based on their assessment of ISA 701, all reports should contain at least one key audit matter. This is also supported by findings from the first-year practice in the UK, where the majority of KAMs reported lies between three and five.

Auditor	0 KAMs reported	1 KAM reported	2 KAMs reported	3 KAMs reported	4 KAMs reported	5 KAMs reported
BDO	0 %	19 %	50 %	6 %	25 %	0 %
Deloitte	0 %	11 %	32 %	42 %	16 %	0 %
EY	7 %	44 %	31 %	15 %	2 %	0 %
KPMG	0 %	20 %	20 %	30 %	25 %	6 %
PwC	0 %	25 %	46 %	29 %	0 %	0 %
Average	1 %	24 %	36 %	24 %	14 %	1 %

Table 7 - The frequency of number of KAMs reported, shown in percentage

Since this study finds differences in the average number of KAMs reported between the audit firms, potential impact factors related to the number of KAMs reported is investigated. The below analysis examines whether there is a correlation between the number of KAMs reported and the company's Price/Book ratio.

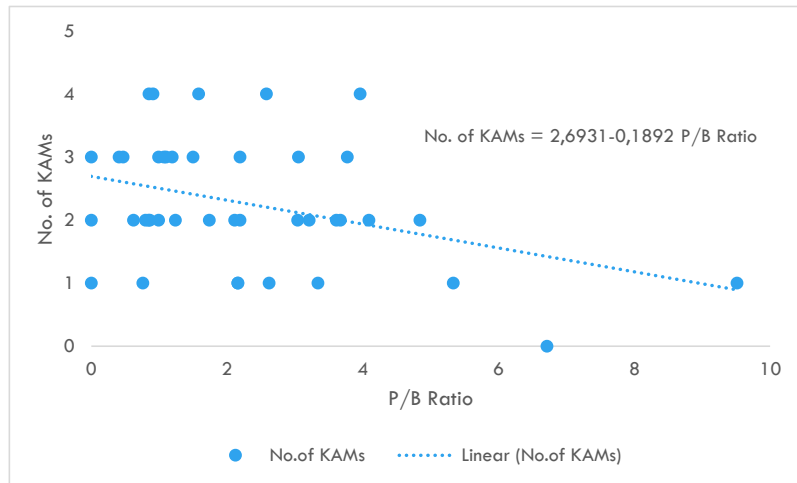


Figure 6 - Price/Book-ratio in relation to the number of KAMs. Source: Bloomberg

A low P/B ratio should imply a high number of reported KAMs, since an internal overestimation of the company's equity usually increases the company risk. The analysis shows the allocation between each company's P/B ratio and the corresponding number of KAMs. A slight tendency is discovered, where the

average number of KAMs is higher when the P/B ratio is low, which was expected. The correlation is significant at a 5 % level, indicating that the number of KAMs reported increases as the P/B ratio decreases, and opposite.

### 5.2 The Type of Key Audit Matters Reported

In total, this sample detects 244 key audit matters, and the figure below shows the wide range of the reported KAMs. Despite the range, several KAMs recurred in a large proportion of the audit reports.

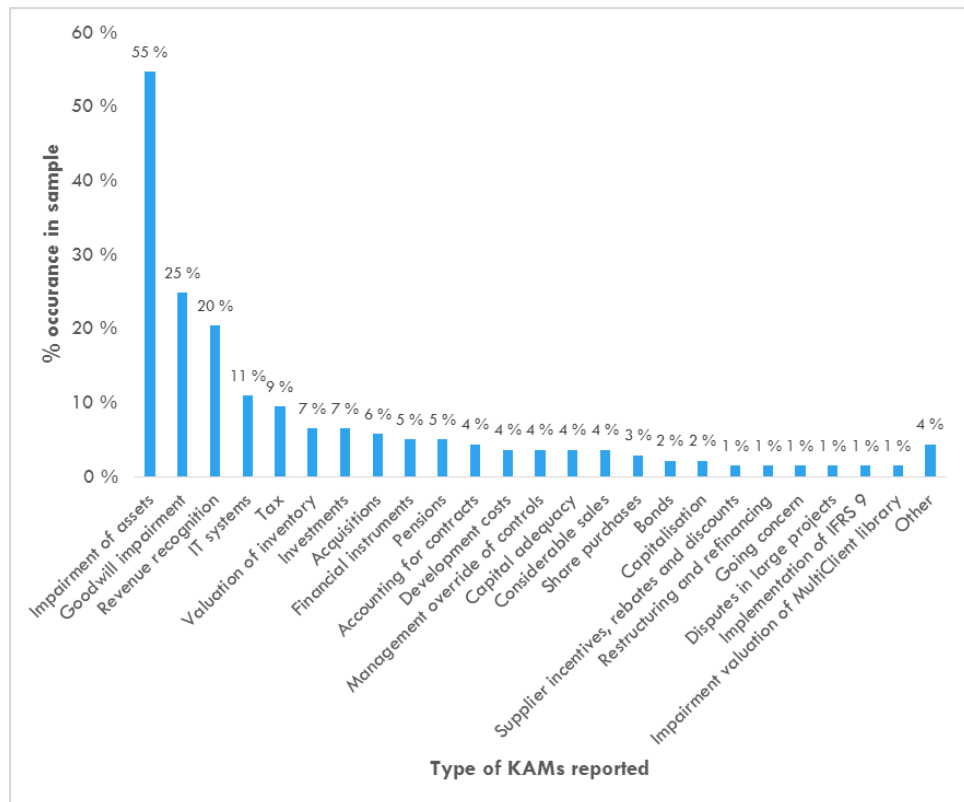


Figure 7 - The occurrence of each key audit matter reported, shown in percentage

Similar to findings from the UK, 'impairment of assets' and 'goodwill impairment' were the most frequent KAMs reported. 'Impairment of assets' was included in 55 % of the Norwegian audit reports, and 'goodwill impairment' in 25 % of the audit reports. As both are critical areas of management judgement and significant to the valuation of most companies, the high proportion of both KAMs was expected.

'Revenue recognition' is the third most reported KAM in this analysis. 'Revenue recognition' was one of the most common KAMs in the UK, and was thus anticipated as a frequent reported KAM in the Norwegian audit reports as well.

'IT systems' and 'tax' also recurs in a large proportion of the audit reports, respectively present in 11 % and 9 % of the audit reports in this sample. 'Tax' was the second most reported KAM in UK, and thus expected among the five most reported key audit matters in Norway. As several issues arise when a company has deferred taxation balances or participates in overseas jurisdictions, tax is often considered a complex area of audit.

This thesis attempts to find the potential differences in the reporting practices of KAMs between the big five audit firms in Norway. In order to identify such differences, it is relevant to examine the most frequent reported KAMs within each audit firm. Figure 8 shows the proportion of the five most reported KAMs in Norway divided into each audit company.

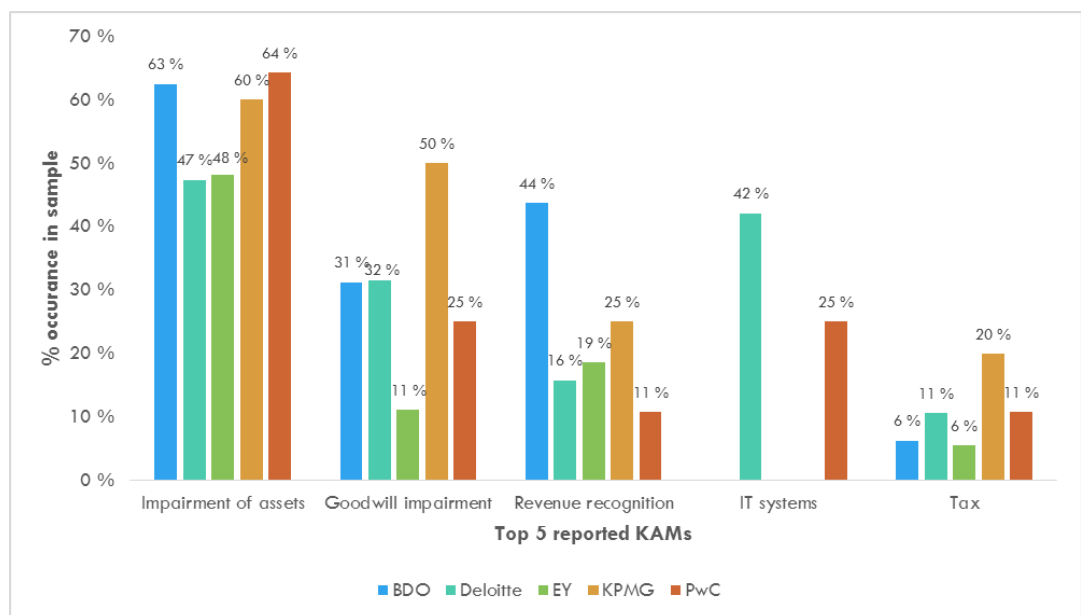


Figure 8 - Top five key audit matters, shown in percentage

'Impairment of assets' is the most frequently reported KAM in all of the big five audit firms in Norway. PwC, BDO and KPMG are above the average, including impairment of assets in respectively 64 %, 63 % and 60 % of their audit reports in this sample. Deloitte report 'impairment of assets' to the least extent, nevertheless

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it is included in as much as 47 % of their reports. The respondents from the big five audit firms expected a high proportion of 'impairment of assets' included in the Norwegian audit reports. KPMG's respondents explain that impairment of assets is a direct consequence of current difficult market conditions in Norway, including the fall in oil prices. Oil, oil-services and shipping are highly affected by the changes in oil prices, and KPMG state that a high degree of impairment of assets in Norwegian companies is thus natural.

Potential underlying reasons for why 'impairment of assets' is the most frequently reported KAM have been of interest to investigate. In this case, an analysis of its connection with the Price/Book ratio is examined. A P/B ratio below one should indicate company impairments. If the company has a low P/B ratio (below 1), it is thus expected that the company includes 'impairment of assets' as a KAM. The findings of the analysis reveal that when the P/B ratio is above one, 'impairment of assets' is included as a KAM in 44 % of the audit reports. When the P/B ratio is below one, 'impairment of assets' is included in 85 % of the audit reports. This indicates a connection between a company's P/B ratio and the inclusion of 'impairment of assets' as a KAM in its audit report.

The percentage of reports including 'goodwill impairment' differs considerably between the five audit firms. KPMG include this as a key audit matter in 50 % of their audit reports. They are the only company far above the average. EY, however, include 'goodwill impairment' as a KAM in only 11 % of their audit reports in this sample. The respondent from EY indicate that the differences are caused by varying assessments of what should be included as a key audit matter. They explain in the interview that they include goodwill as a KAM only if it is considered a specifically significant impairment indicator.

Another key audit matter that varies between the audit firms is 'revenue recognition'. EY, Deloitte and PwC include this in less than 20 % of their reports, while KPMG and BDO include it in respectively 25 % and 44 %. The respondents from all the five audit firms state that revenue recognition is a difficult area to consider in terms of KAM. Since there is an ongoing risk in the assessment of revenue recognition for the majority of all companies, different opinions on

whether this should classify as a KAM exists. The overall perception is that revenue recognition is not considered a KAM unless complicated discretionary assessments related to revenue has occurred during the relevant fiscal year. However, the respondent from BDO indicate that revenue recognition should be considered a KAM in line with all other audit matters. They admit that the threshold to include revenue recognition as a key audit matter has been low for BDO.

In conjunction with analysing the key audit matter 'revenue recognition', conducting an industry analysis is of interest. The figure below illustrates the variations in the inclusion of revenue recognition as a key audit matter, in terms of both audit company and industry.

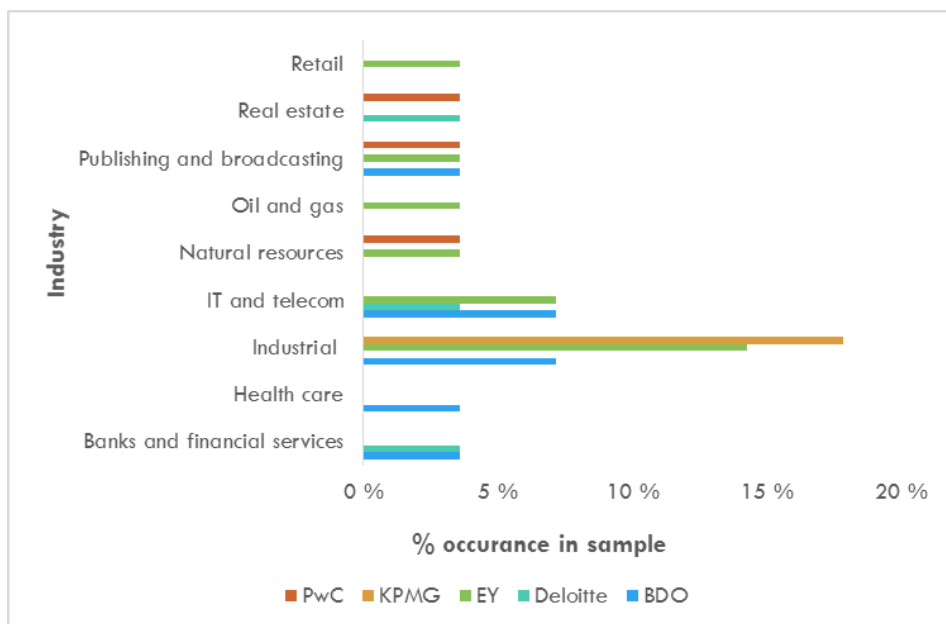


Figure 9 - The share of 'revenue recognition' in each industry, shown in percentage

KPMG include 'revenue recognition' in audit reports only related to the industrial sector. The company explains through the interview that several of their clients operate within the large industrial sector with construction contracts. KPMG claim that the assessment of revenue recognition is more complicated if the revenues of the company are measured by percentage of completion. EY include revenue recognition as a KAM in six out of nine industries despite the lower proportion of reports including revenue recognition as a KAM. BDO has the highest proportion

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of 'revenue recognition' included in their audit reports and include this as a KAM in five out of nine industries.

Deloitte and PwC are the only audit firms in this analysis that include 'IT systems' as a key audit matter, in respectively 42 % and 25 % of their audit reports. PwC and Deloitte explain that this is a result of varying assessments of risks related to IT systems. They have regarded 'IT systems' as a KAM in the majority of the banks and insurance companies' audit reports, and refer to the fact that such companies are unable to operate unless the IT systems work sufficiently. KPMG have deliberately abstained from including IT systems as a KAM in their audit reports. They explain that they generally do not see this as a key audit matter. However, they agree that IT systems can be regarded a KAM given certain criteria, for instance if the audited company transits to a completely new IT system.

KPMG includes 'tax' as a key audit matter in 20 % of the sampled audit reports, which is more frequent than the average. Through the interviews, KPMG's respondents suggest that this might be random. On average, they include more KAMs in their reports compared to their peers, and argue that the high number of KAMs must be reflected somewhere. They state that this might be the case with 'tax'.

'Tax' is to a much smaller extent included as a KAM in Norwegian audit reports compared to the UK. In the UK, 'tax' was included in 46 % of the audit reports the first year of implementation, representing the second most reported KAM (FRC, 2015). 'Tax' was included as a KAM in 11 % of the Norwegian audit reports. KPMG explain that they expected a low proportion of Norwegian reports including 'tax' as a KAM. Since Norwegian auditors sign the tax returns of their own clients, their assessment of the riskiness of tax is usually relatively low. In the UK, for instance, this is not the auditor's responsibility, and the assessment of risks related to tax should thus be higher. KPMG consider 'tax' a KAM particularly related to deferred tax assets or tax loss carry forwards.



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### 5.3 The Description of Key Audit Matters

The new ISA requires that: "in order to be useful to users of the financial statements, the explanations of the matters required to be set out in the auditor's report (...) shall be described in a way that enables them to be related directly to the specific circumstances of the audited entity and are not, therefore, generic or abstract matters expressed in standardised language" (FRC, 2015). In the following, this thesis will evaluate the two sections in which KAM is divided; the description of the selected KAM, and the description of 'how the matter was addressed in the audit' (/the 'Audit Response'). The descriptions of the key audit matters in each of the 137 audit report will be analysed first.

Findings indicate that there are large differences between the audit reports and that some audit reports appear to provide more granular and entity-specific descriptions of the key audit matter. Overall, 49 % of the KAMs are written in a more granular and less generic matter (categorised 'satisfactory'), 35 % were largely generic in nature, not linking it to the specific entity ('unsatisfactory'), while 14 % contains reports that deliver descriptions of KAMs where certain important aspects are missing (categorised 'neither'). The criteria utilized to assess whether a report contains satisfactory descriptions or not are described in chapter 4.1.

Auditor	Satisfactory descriptions of KAM	Unsatisfactory descriptions of KAM	Neither
BDO	44 %	31 %	25 %
Deloitte	63 %	32 %	5 %
EY	43 %	37 %	11 %
KPMG	55 %	25 %	20 %
PwC	39 %	50 %	11 %
<b>Average</b>	<b>49 %</b>	<b>35 %</b>	<b>14 %</b>

*Table 8 - The assessment of each audit firm's description of key audit matters*

The table above shows the differences between the five audit firms. Deloitte provide the most granular, non-standardised key audit matter descriptions. Over sixty percent of their reports include KAMs that cite granular descriptions with specific and relevant information related to FY 2016. Deloitte is moreover the audit company with fewest key audit matter descriptions placed in the 'neither'-

category, indicating that in each of their audit reports, the different KAMs are described with a similar level of detail.

An example of a granular KAM- description, provided by Deloitte on Storebrand ASA, is retrieved from one of the audit reports in this thesis' sample selection:

*Solvency II notes to the financial statements*

Key audit matter

The new European solvency regulation for insurance companies, Solvency II entered into force 1 January 2016. The Solvency II directive is implemented in Norwegian law through the Norwegian Act on Financial Undertakings and Financial Groups and the Norwegian Solvency II regulation.

The regulation of 18 December 2015 on Financial Statements for life insurance companies requires disclosures about Solvency II in the financial statements. Note 2 describes important accounting estimates and judgement and note 47 describes solvency capital including transitional rules, solvency capital requirement and solvency margin with transitional rules and important models, assumptions and estimates used in the calculations of these numbers.

The models used as a basis for the calculation of solvency capital requirement and solvency capital including transitional rules are based on a number of requirements and assumptions that are partly specified in the regulations and partly interpreted by Storebrand based on the regulations. The calculations of the solvency capital including transitional rules and solvency capital requirement are complex and are based on several uncertain assumptions and estimates. This also includes assumptions regarding future profit margins on insurance products. The models, assumptions and estimates used are crucial to the calculation of the solvency margin.

The fact that compliance with the solvency capital requirement and the minimum capital requirement according to the Norwegian Act on Financial Undertakings and Financial Groups is a basis for the going concern assumption and that the calculations are complex and are based on several assumptions and estimates causes it to be a key audit matter.

*Figure 10 - Example of granular description of a key audit matter, issued by Deloitte*

The KAM 'Solvency II notes to the financial statements' presents information specifically relevant for FY 2016, it includes company-specific information and explains the background for the assessments.

KPMG is the other company, in addition to Deloitte, which tends to break down the description of the KAMs by specific-focused analytics. One example is the report on Ocean Yield ASA, which appears to have thorough descriptions and detailed narrative explanations of the KAMs. Attached is an excerpt of the description of the first key audit matter, 'Impairment':

**The Key Audit Matter**

Vessels and other fixed assets includes vessels on operating lease contracts with customers and newbuildings under construction related to arranged operating lease agreements total USD 1 243.8 million as at 31 December 2016.

The Group's long-term charters reduce exposure to volatility in market conditions provided that customers continue to have the ability to perform on their contractual obligations. These long-term charters also reduce the volatility of the impairment analysis and the related sensitivities. As discussed in notes 10 and 14 to the consolidated financial statements, one of the Group's long-term charters was cancelled due to non-payment. In addition, another customer has agreed to the terms of a financial restructuring with its creditors and is in the process of implementing the restructuring plan. Due to these events as well as continuing challenges facing the oil and gas sector and uncertainties about future developments, there is an increased risk that book value of vessels may need to be adjusted downwards.

Management's assessment of valuation of vessels was therefore significant to our audit. Management's determination of the recoverable amounts related to vessels under operating leases includes:

- Assumptions regarding cash flows forecasts;
- Discount rates;
- Customer credit risk; and
- Residual values.

Significant auditor judgment is required when evaluating whether management's assumptions are reasonable and supportable, and whether the residual values can be considered reliable.

Figure 11 - Example of granular description of a key audit matter, issued by KPMG

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The description above is complementary, concrete and company-specific. In addition, it provides the reason why the aspect is considered a key audit matter, which gives depth to the description.

Although many of KPMG's reports deliver granular descriptions of the KAMs, they score significantly higher than Deloitte in terms of reports with KAM-descriptions in the 'neither'-category. This could indicate that the KPMG audit reports deliver KAMs with varying degree of detail, where for instance the first KAM is explanatory, detailed and specific, while the remaining KAMs appear more standardised and generic.

PwC, in comparison, deliver granular descriptions of KAMs in only 39 % of their reports. 50% of the PwC descriptions of KAMs are categorised as generic and standardised, and thus assessed 'unsatisfactory' in this analysis. The following clip illustrates this tendency: PwC's report on Sparebank 1 SR-Bank, where the KAM 'IT systems' appears standard and short:

*IT-systems and the underlying systems  
for processing transactions*

We have addressed this area because it is important for the bank's financial reporting systems, and their business model is dependent on complex IT systems. Weaknesses in automated processes and controls can potentially lead to a significant risk in the daily operations and risk of misstatements.

*Figure 12 - Example of generic description of a key audit matter, issued by PwC*

In the description of KAM, the PwC reports tend to explain that the area has been complex and linked to discretion, however provide no further specific information related to the company. As it appears in the description of 'IT systems' (above), PwC explain that it is an important and complex area, however omits to explain the reason why they consider it complex.

PwC suggest through the interview that their assessments of the KAMs is highly coinciding by the company's own key judgements. Through the key judgements,

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most of the company risks are already presented in the annual report, thus an equivalent description of the risks in the audit report is regarded unnecessary. Although PwC have the highest proportion of reports placed in the 'unsatisfactory'-category, a selection of their reports are considered highly granular, which the next chapter will highlight.

#### ***5.4 The Description of 'How the Matter was Addressed in the Audit'***

Similar to the description of key audit matters, this thesis provides an evaluation of the descriptions of 'how the matter was addressed in the audit' in each of the 137 audit reports.

Findings show that selected audit reports appear more granular and entity-specific in the description of the 'how the matter was addressed in the audit'. As shown in table 9, there are also differences between the audit firms. Deloitte has the highest number of audit reports with granular descriptions of 'how the matter was addressed in the audit'. EY and BDO are the only companies below the average, with respectively 48% and 50% of their audit reports providing granular descriptions of 'how the matter was addressed in the audit'. EY and BDO have the highest share of audit reports placed in the 'neither'-category.

<b>Auditor</b>	<b>Satisfactory descriptions of AR</b>	<b>Unsatisfactory descriptions of AR</b>	<b>Neither</b>
BDO	50 %	19 %	31 %
Deloitte	84 %	11 %	5 %
EY	48 %	31 %	13 %
KPMG	80 %	15 %	5 %
PwC	75 %	21 %	4 %
<b>Average</b>	<b>67 %</b>	<b>19 %</b>	<b>12 %</b>

*Table 9 - The percentage of satisfactory and unsatisfactory descriptions of 'how the matter was addressed in the audit'*

Each of the audit firms provide more granular and satisfactory descriptions of 'how the matter was addressed in the audit', compared to the descriptions of KAMs. Through the interviews, the audit firms reveal a significant and time-consuming focus on describing 'how the matter was addressed in the audit'. They suggest that the large proportion of satisfactory descriptions of 'how the matter was addressed in the audit' is most likely due to extensive quality control routines

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within the companies. The BDO respondent indicate that the section describing 'how the matter was addressed in the audit' has been the most important part of their reporting of KAM, and explains that this is because the description of each key audit matter should already appear in the company accounts. PwC have similar explanations as BDO, and the respondent suggest that particular focus has been placed on 'how the matter was addressed in the audit'. The aforementioned is particularly evident for PwC, as they delivered 75 % granular descriptions of 'how the matter was addressed', and only 39 % granular descriptions of KAM.

An example of a granular description of 'how the matter was addressed in the audit' is on retrieved from PwC's audit report on Norwegian Royal Salmon:

#### **How our audit addressed the Key Audit Matter**

The Group's biomass system include information on number of fish, average weight and biomass per site.

We have reconciled the movement in the inventory of live fish stock (biomass and number of fish). The movement in number of fish is the total of smolt stocked, loss of fish and harvested fish for the period. The movement in biomass equals the total of stocked biomass, net growth and harvested biomass for the period. We focused mainly on the number of smolt stocked and the net growth in kg for the period, as these have the most significant impact on the measurement at year-end.

We have reviewed the Group's routines for registration of the number of smolts stocked. To ensure accuracy of the number of smolt registered in the biomass system we checked a selection of registered smolt stockings from the biomass system against supporting documentation.

The period's net growth correspond to the feed consumption in the period divided by the feed conversion rate. The feed consumption is closely related to the feed purchase in the period. To evaluate the feed consumption and feed purchase of the period we have reviewed the Group's routines for reconciling the feed inventory and reconciled feed purchase against external confirmations from the two main suppliers. Furthermore, we have compared the accumulated feed conversion rate for the stock against our expectation based on industry data per farming region. Where the feed conversion rate differed from our expectation, we obtained explanations and supporting documentation. Our work supported that the estimated growth was reasonable.

To evaluate the historical accuracy of the Group's estimates on biomass and number of fish, we have reviewed the harvesting deviations for the period. We found that the deviations were as expected.

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We challenged the Group's model used to calculate the fair value by comparing it to the criteria in IAS 41 and IFRS 13. We found no obvious exceptions.

We then examined whether the biomass in kg and number of fish used in the calculation corresponded to the biomass and number of fish in the Group's biomass system, and tested that the model made mathematical calculations as intended.

After ensuring these fundamental assumptions were in place, we considered if the assumptions made by management when valuation the fair value was reasonable. We did this by discussing the assumptions with the group management and comparing them to e.g. historical data, industry data and observable market data. We found that the assumptions were reasonable.

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*Figure 13 - Example of granular description of 'how the matter was addressed in the audit', issued by PwC*

There seems to be great variations in the audit reports of EY in terms of granularity. Although they are less granular in their descriptions of 'how the matter was addressed in the audit' compared to the other big five, selected audit reports stand out as particularly satisfactory. The following clip is an example of a granular description of 'how the matter was addressed in the audit', issued by EY on Hexagon Composites ASA, related to the KAM 'Merger with Agility Fuel System – loss control in a subsidiary':

We reviewed the management's assessment of the transaction including the loss of control. We assessed whether the accounting treatment was consistent with the requirements of IFRS, and evaluated relevant supporting documentation, including the merger agreement. The book value for the CNG-business was based on the carve-out balance sheet at October 3, 2016 and we tested that the appropriate accounting entries, including de-recognition of merged assets and liabilities, were recorded. We evaluated managements assumptions related to the fair value of the new entity, the use of comparable marked date for peer companies and calculation of implicit value of the Hexagon cash payment. We further considered management's assessment of the allocation of excess value over book value allocated to trade name, technology, customer relationships and goodwill.

We refer to disclosures in note 5 and 26 of the financial statements.

*Figure 14 - Example of granular description of 'how the matter was addressed in the audit', issued by EY*

Another interesting observation is that in each singular audit report, there seems to be no direct relationship between the quality of the description of KAM- and the description of 'how the matter was addressed in the audit'. Some audit reports have generic and standard descriptions of KAMs while the description of 'how the matter was addressed in the audit' is granular and entity-specific. This goes for the opposite as well.

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Auditor	Satisfactory in both KAM and AR
BDO	31 %
Deloitte	58 %
EY	28 %
KPMG	50 %
PwC	39 %
<b>Average</b>	<b>41 %</b>

*Table 10 - The percentage of satisfactory descriptions of both KAM and 'how the matter was addressed in the audit'*

The table above shows the percentage of each audit report that are satisfactory both in terms of the description of KAM and the description of 'how the matter was addressed in the audit', meaning that both sections are considered 'satisfactory' according to the utilized criteria in this analysis. Findings indicate that Deloitte have the highest percentage of audit reports that meet the requirements in both sections. The interview respondents from Deloitte explain that this is probably due to extensive quality control procedures and that they have one single group controlling all the audit reports. They have spent great resources on challenging the teams both in terms of content and in terms of quality, assuring that all the audit procedures included in the audit report actually were completed.

KPMG has the second largest proportion of audit reports meeting the requirements in both sections, despite the high number of audit reports placed in the 'neither'-category on the description of key audit matters. EY is at the opposite end of the scale, and only 28 % of their audit reports meet the requirements in both sections. The respondents from EY emphasize that they have focused mostly on being comprehensible and precise in their descriptions, and that only the key procedures have been explained.

The PwC audit report on Austevoll Seafood ASA was awarded 'this year's best audit report' on 'DNR-dagen 2017'<sup>4</sup>, for its great descriptions of both KAM and 'how the matter was addressed in the audit'. The jury, consisting of professional annual report users, stated that the descriptions of the key audit matters appeared

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<sup>4</sup> Similar to the IMA Auditor Reporting Award in the UK



highly granular and entity-specific. The descriptions of why the specific KAM was included were also considered thorough and concrete. In this particular audit report, the descriptions provide the user with good insight into the factors that are of importance in the assessment of the specific KAM. The audit procedures are linked to the specific KAM, described in detail, and gives the user confidence that the auditor has assessed the relevant KAM in a satisfactory manner.

The clip below is the KAM section of Austevoll Seafood ASA's audit report. The description of KAM is to the left and the description of 'How the matter was addressed in the audit' is to the right.



Independent Auditor's Report - Austevoll Seafood ASA

Key Audit Matter	How our audit addressed the Key Audit Matter
<p><i>Purchase of Havfisk ASA and Norway Seafoods Group AS</i></p> <p><i>(See also note 6 on business combinations)</i></p> <p>The Group purchased the shares of the companies Havfisk ASA and Norway Seafoods Group AS in 2016 through the subsidiary Lerøy Seafood Group ASA. The purchased companies are consolidated in the Group's financial statements from September 2016.</p> <p>The business combination results in a significant increase in book values of vessels and intangible assets (licenses). Due to the size of the purchase, and the judgement involved in identifying and valuing the assets, we focused on the Group's preliminary purchase price allocation.</p> <p>We mainly focused on the valuation of vessels and licenses, and the technical calculation of goodwill and deferred tax.</p>	<p>We obtained the Group's preliminary purchase price allocation for the purchases of Havfisk ASA and Norway Seafoods Group AS. First, we evaluated the Group's purchase price allocation model by comparing it to the criteria in IFRS 3 and found no obvious exceptions. Secondly, we reconciled the balance sheet in the purchase price allocation model to the underlying balances for Havfisk ASA and Norway Seafoods Group AS respectively, without identifying any significant differences.</p> <p>We then obtained and reviewed the Group's valuation of vessels and licenses. We challenged management's assumptions regarding future prices and volumes, and tested that the model made mathematical calculations as intended.</p> <p>Furthermore, we challenged the Group's assumptions related to the allocation of the excess value. Our work supported that the allocation of the excess value was fair. Finally, we also made sure that the technical calculation of deferred tax on the excess values was performed correctly.</p>
<p><i>Measurement and valuation of biological assets</i></p> <p><i>(see also note 2 accounting principles, note 4 significant estimates and judgement, and note 21 biological assets)</i></p> <p>As described in the financial statements Austevoll Seafood ASA value biological assets to their fair value according to IAS 41. At the balance sheet date the fair value of biological assets was MNOK 6,755, out of which MNOK 3,893 is historical cost and MNOK 2 861 is adjustment to fair value.</p> <p>Biological assets comprise ova (eggs), juveniles, deaner fish, broodstock and fish held for harvesting purposes (ongrowing stage).</p> <p>When auditing inventories the auditing standards require that the auditor attend the physical inventory counting when this is possible. The biological assets are by</p>	<p>The Group's biomass system include information on number of fish, average weight and biomass per site.</p> <p>We have reconciled the movement in the inventory of fish held for harvesting purposes (biomass and number of fish) for the farming regions. The movement in number of fish is the sum of opening stock, smolt stocked, loss of fish and harvested fish for the period. The movement in biomass equals the sum of opening biomass, stocked biomass, net growth and harvested biomass for the period. We focused mainly on the number of smolt stocked and the net growth for the period, as these have the most significant impact on the measuring at year-end.</p> <p>We have reviewed the Group's processes for registering the number of smolts stocked. Furthermore, we have reconciled a sample of registered smolt stockings in the biomass system against supporting documentation in the form of e.g. supplier invoice for smolt purchased</p>

(2)



nature difficult to count, observe and measure due to lack of sufficiently accurate measuring techniques that at the same time does not affect fish health. As a result, there is some uncertainty related to the number of fish and biomass in the sea. We have therefore focused on measurement of the biological assets (number and biomass), and specifically the inventory of live fish held for harvesting purposes (ongrowing), which constitutes the majority of the value of the biological assets.

The fluctuations in the value estimate that arise due to for instance changes in market price, may have a significant impact on the operating profit for the period. The Group therefore show the effect from changes in fair value estimates as a separate line item, before operating profit.

In 2016 the Group changed its model used for estimating the fair value of biological assets. We refer to note 2 and note 21 for further details.

We focused on the valuation of the biological assets due to the size of the amount and the effect the fair value estimate has on operating profit. Further, the company has changed its calculation model during the year and the calculations are already complex and there is a fair amount of judgement involved.

#### *Valuation of licences and goodwill in South America*

*(See also note 15 on intangible assets)*

On the balance sheet date, the book value of licences and goodwill related to the business segments in South America was MNOK 1,437. No impairment charges related to these assets was recognised in the income statement.

externally, and vaccination report or waybill for smolt produced internally.

The period's net growth corresponds to the feed used in the period divided by the feed conversion rate (kgs of growth per kg feed used). The feed usage is again closely associated with the feed purchase for the period. To evaluate the feed usage for the period were viewed the Group's controls for reconciling the feed inventory, reconciled the feed accounts payables at year-end against a confirmation from the feed supplier, and tested a sample of feed invoices throughout the year. Furthermore, we have compared the feed conversion rate for the period against our expectation based on industry data per farming region. Where the feed conversion rate differed from our expectation, we have obtained explanations and supporting documentation from the Group. Our procedures substantiated that the growth for the year was reasonable.

In order to challenge the historical accuracy of Group's biomass estimates we have reviewed the harvest deviation for the period. We found the accumulated deviations to be as expected. We challenged the Group's model for calculating the fair value of biological assets by assessing the model against the criteria in IAS 41 and IFRS 13. We found no obvious exceptions. We then examined whether the biomass and number of fish used in the calculation corresponded to the biomass and number of fish in the Group's biomass system, and tested that the model made mathematical calculations as intended.

After ensuring that these fundamentals were in place, we assessed if the assumptions made by the Group when estimating the fair value was reasonable. We did this by discussing the assumptions with the group management and comparing them to among other historical data, industry data or observable market data. We found that the assumptions were reasonable.

We obtained the Group's impairment calculation related to licences and goodwill. We considered the elements in the model against the accounting standards and did not find any obvious departures. Further, we evaluated the mathematical accuracy in the model on a test basis without finding any deviations.

(3)



We focused on the valuation of licences and goodwill in South America as there are impairment indicators identified for parts of the business. Of further significance, the calculations are complex and the assumptions in the estimate involves management judgement.

We challenged the Group's use of important assumptions in the model related to future volume, price, operating costs, reinvestments and discount rate. This was done by comparing the assumptions against industry data, historical results and budgets approved by the Board of Directors.

We compared the price assumptions in the budgets against expected price trends according to the OECD-FAO report "Agricultural Outlook 2016-2025". Further, we evaluated the volume assumptions against historical levels and updated counting performed by independent institutions on behalf of the governments in Chile and Peru.

We reviewed the operating costs development in the forecast period against historical levels and budgets approved by the Board of Directors.

We found that the assumptions in the model was in accordance with external data and our expectation for the development of the industry.

We have reviewed the discount rate and compared the input in the discount rate with external data. We found that the assumptions were reasonable.

Figure 15 - The winner of DnR-dagen 2017 'this year's best audit report', issued by PwC

There are also differences in the audit firms' practices in the inclusion of findings in the section on 'how the matter was addressed in the audit'. The respondents from Deloitte emphasize that the new audit standard explicitly suggest that the KAM section should not include sub-conclusions. They state that there seems to be a fine line between findings and sub-conclusions. EY and Deloitte have therefore decided not to include findings in their audit reports.

Auditor	Inclusion of findings
BDO	25 %
Deloitte	0 %
EY	0 %
KPMG	25 %
PwC	82 %
<b>Average</b>	<b>26 %</b>

Table 11 - The inclusion of findings, shown in percentage

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KPMG and BDO include findings in 25 % of their audit reports; however, their reasons for including findings differs. BDO have a policy to abstain from including findings and expect a decline in number of audit reports including findings in the coming years. The respondents from KPMG explain that they have had no policy whether to include findings or not.

PwC have the most frequent use of findings in their audit reports, which was expected due to company announcements prior to the implementation. As seen in figure 15, 'this year's best audit report' awarded by 'DnR-dagen 2017', Austevoll Seafood, included findings at the end of each description of 'how the matter was addressed in the audit'. The inclusion of findings was, according to the jury, part of the reason why the audit report was considered the best audit report of the year.

Although PwC have a policy to include findings, 18 % of their audit reports do not include findings. The respondent from PwC explains that the audit partners may have had different motives not to include findings and that this has been accepted.

### ***5.5 The Use of Advanced Language in the KAM Section***

Language is another important element that affects the impression and understanding of the KAM-section in the audit report. Language is also an area in which the audit firms can distinguish themselves, either positively or negatively. Although there is a general expectation of reduced standard- and advanced language accompanying the new audit report standard, almost twenty percent of all the 137 audit reports describe the KAM-sections with complex language.

<b>Auditor</b>	<b>Share of advanced language</b>
BDO	13 %
Deloitte	21 %
EY	20 %
KPMG	17 %
PwC	18 %
<b>Average</b>	<b>18 %</b>

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*Table 12 - Audit reports including advanced language, shown in percentage*

The percentage of audit reports with advanced language is relatively equal in all the five audit companies. BDO is the only audit company standing out with 13% of their audit reports using an advanced language, hence the vast majority of their audit reports are written in an easily understandable language. BDO's respondent explain that since the financial statement user not necessarily possess a background within audit, their focus has been on writing as comprehensible as possible. BDO is furthermore the only company with one single person controlling all the published audit reports, which assures the same control check for all the published reports. BDO explain that a lot of effort has been on giving feedback related to language, making the reports more readable.

Despite the low proportion of audit reports containing advanced language, some audit reports appear advanced and technical. One example is the EY audit report on Zalaris ASA:

**Customer Projects**

The group capitalises costs related to outsourcing contracts in the implementation phase. Contracts are customised for the individual projects. The capitalised costs comprise internal hours on the specified project and external license cost. The hourly rates applied are based on salary costs and estimates on indirect cost allocation and utilisation. Customer advance payments are recorded as a deduction in the balance for customer projects. When the implementation phase is completed, deferred costs are expensed and the advanced payment are recognised as revenue evenly over the period the outsourcing services are provided. Accounting for customer projects is a key audit matter because of the complexity in the contracts and because judgement is involved in estimation and allocation of costs and advance payments to the individual customer project.

We assessed the accounting policy on capitalization of customer projects and the related revenue recognition. We tested the design and effectiveness of controls related to time registration, the estimated hourly rates, and verified these to factual rates of implemented projects. We also tested capitalized internal cost and compared actual hours and rates applied towards budget. For external cost we verified the amounts to vendor invoices. We compared the terms of the contract to the revenue recognised.

We refer to note 2 and 11 in the consolidated financial statement.

*Figure 16 - Example of the use of advances language, issued by EY*

The section above seems to be written for professionals and it is difficult to relate to the argumentation without an academic audit background. Unfamiliar terminology and advanced sentence structure characterize most of the audit reports that have been considered to have advanced language.

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### 5.6 The Presentation Format of the KAM Section

Auditor	Tabular presentation
BDO	Yes
Deloitte	Yes
EY	No
KPMG	Yes
PwC	Yes

*Table 13 - The use of tabular presentations*

The big five audit firms reveal through the interviews that they have carefully chosen which way to best present the KAM section in their audit reports. Colours, logos, fonts, bullet points and tables are used to PR a certain company expression. While BDO, Deloitte, KPMG and PwC all present their key audit matters in a tabular form, EY present their key audit matters in plain text. From the IMA Auditor Reporting Awards in UK, it became clear that a large share of financial statement users preferred a more figurative presentation of the KAMs. This was expected to make the text more transparent and to make it easier to get a quick overview of the findings (Kuan, 2016). EY's reason for choosing a text-based presentation is to limit the amount of information included in the KAM section, and refrain from including anything but the most important.

Audit reports from other countries, such as the UK, seem to put more effort in design and fancy presentations of the KAM sections compared to the first-year audit reports from Norway. However, the majority of the Norwegian audit reports present the elements of KAMs in tabular presentations and transparent alignments. One example is the audit report on Link Mobility Group ASA, issued by BDO:



**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 key audit matter	How the key audit matter was addressed in the audit
<p><b>Impairment of intangible assets</b></p> <p>Carrying amounts of goodwill and other intangible assets resulting from the Group's acquisitions of subsidiaries, constitute the greater part of the assets in the Group's statement of financial position. As at 31 December 2016, goodwill and other intangible assets amounting to NOK 757 million represents 67 % of total assets.</p> <p>Management performs an annual goodwill impairment test by estimating the recoverable amount of goodwill. The determination of recoverable amounts requires application of significant judgment by management, in particular with respect to cash flow forecast and the applied discount rate.</p> <p>Due to the materiality, complexity and estimation uncertainty concerning goodwill, we consider impairment of goodwill a key audit matter in the audit of the Group.</p> <p>See note 6 to the consolidated financial statements.</p> <p>The Group's accounting policy regarding impairment of intangible assets is disclosed in note 1.13 to the consolidated financial statements.</p>	<p>Our audit procedures included an evaluation of the key assumptions applied in the valuation model, such as revenue growth, EBITDA margin, terminal growth rate, discount rate and remaining useful life.</p> <p>We involved our valuation experts to assist us with our assessment of the discount rates, expected inflation rates and the appropriateness of the model used.</p> <p>In addition, we performed the following audit procedures:</p> <ul style="list-style-type: none"> <li>• we evaluated the reliability of estimates used by management by comparing forecasts made in prior years to actual outcomes</li> <li>• we assessed key inputs in the calculations such as revenue growth, EBITDA and discount rate, by reference to management's forecasts</li> <li>• we assessed management's sensitivity analysis focused on what impact on recoverable amount reasonable changes in assumptions such as revenue growth, EBITDA and discount rate would have</li> <li>• we tested the mathematical accuracy of the valuation model</li> </ul> <p>Furthermore, we have evaluated the adequacy of the disclosures provided in the notes covering impairment.</p>

Figure 17 - Example of a tabular presentation, issued by BDO

The respondents from Deloitte explain that the difference between UK and Norway in this manner could be due to inequalities in the content of the audit report. In UK, most of the graphs and charts are utilized on 'materiality' or the 'scope of the audit', sections that are not required in the Norwegian ISA 701. Deloitte assume that UK make use of graphs and charts on sections in the audit report that are regarded as more advanced and hard to understand for the reader.

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All the big five audit firms agree that the design of the KAM section is highly important, as it affects both the impression and the understanding of the section. Several of the audit firms are interested in making design changes to the KAM section in the coming years, and they expect a development towards a more graphic and entity-specific layout.

### ***5.7 Empirical Findings – An Outline***

The findings of this study reveal that the number of reported key audit matters differs between the big five audit firms in this sample. The Norwegian audit reports include on average 2.28 key audit matters. On average, KPMG report the highest number of KAMs (2.75 KAMs) while EY reports the least (1.59 KAMs). EY is alone in reporting zero KAMs in certain audit reports, and KPMG is alone in reporting five KAMs. The differences in the number of KAMs reported are due to various assessments and interpretations of ISA 701. In addition, findings reveal that there is a correlation between a company's price/book-ratio and the number of KAMs reported. The number of KAMs reported increases as the P/B ratio decreases, and vice versa.

'Impairment of assets', 'goodwill impairment' and 'revenue recognition' are the most frequently reported KAMs in Norway. All the big five audit firms report 'impairment of assets' to the greatest extent and in total, 55 % of the analysed reports include 'impairment of assets' as a KAM. There is a connection between the Price/Book ratio of a company and the inclusion of 'impairment of assets' as a KAM in its audit report. A P/B ratio below 1 usually indicates inclusion of 'impairment of assets' as a KAM. 'Goodwill impairment' is included as a KAM in 25 % of the sampled audit reports, however the frequency varies between the audit firms. KPMG report 'goodwill impairment' as a KAM in 50 % of their audit reports while EY in 11 % respectively. 'Revenue recognition' was not expected among the top three most frequently reported KAMs in Norway, however it proved to be a KAM in 20 % of the sampled audit reports, representing the third most reported KAM in Norwegian audit reports. Different opinions on whether 'revenue recognition' should classify as a KAM exist between the audit firms. The overall perception is that revenue recognition is not considered a KAM unless



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complicated discretionary assessments related to revenue has occurred during the relevant fiscal year. BDO stands out by reporting 'revenue recognition' in as much as 44 % of their audit reports. 'Tax' is the second most reported KAM in UK and was expected among the top three KAMs in Norway. The reporting on 'tax' differs between the audit firms and it is not among top three most reported KAMs in Norway. Due to the Norwegian auditor's responsibility to sign the tax returns of their clients, the assessment of the risks related to tax appears to be relatively low among Norwegian auditors. 'IT systems' is included as a KAM exclusively in audit reports of Deloitte and PwC. Despite this, 'IT systems' is the fourth most frequently reported KAM in Norway. PwC and Deloitte have regarded 'IT systems' as a KAM in the majority of the banks and insurance companies' audit reports, and refer to the fact that such companies are unable to operate unless the IT systems work sufficiently. KPMG deliberately abstains from including IT systems as a KAM in their audit reports, and explain that they generally do not see this as a key audit matter.

The description of key audit matters differ in granularity between the big five audit firms in Norway. Deloitte provide granular descriptions of KAM to the greatest extent, accounting for 63 % of their audit reports. PwC provide granular descriptions of KAMs to the least extent, accounting for 39 % of their audit reports. Within the PwC audit reports, there are large variations in the level of granularity. In terms of the audit firms' emphasis on the descriptions of KAMs, large differences are identified. The respondent from EY suggests that the descriptions of each KAM should be short and concise, while Deloitte emphasizes the importance of comprehensive and detailed KAM descriptions.

The description of 'how the matter was addressed in the audit' differ in granularity between the big five audit firms in Norway. Deloitte provide granular descriptions of 'how the matter was addressed in the audit' to the greatest extent, accounting for 84 % of their audit reports. EY provide granular descriptions of 'how the matter was addressed in the audit' to the least extent, accounting for 48 % of their audit reports. Although considerable differences between the audit firms are present, all of the audit firms provide granular descriptions of 'how the matter was addressed in the audit' more consistently, compared to the description of KAM. The

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respondents from all of the big five audit firms explain that they have placed focus on describing 'how the matter was addressed in the audit' rather than describing KAMs. There are also differences in the audit firms' practices in the inclusion of findings in the section on 'how the matter was addressed in the audit'.

The level of advanced language in the key audit matter section of the audit report differs between the big five audit firms in Norway. Deloitte provide audit reports with advanced language to the greatest extent, accounting for 21 % of their audit reports. BDO provide audit reports with advanced language to the least extent, accounting for 13 % of their audit reports. The audit firms suggest that language is an important part of ISA 701, and they have focused heavily on internal quality controls to reduce the use of advanced language. Although differences in terms of language are identified, the extent of the difference are relatively small among the audit firms.

The presentation format of the key audit matter section differs slightly between the big five audit firms in Norway. While BDO, Deloitte, KPMG and PwC all present the section of key audit matters in a tabular form, EY present the section in plain text. Beyond this, the only differences identified are related to entity-specific layout, such as colours and logos.

The findings above indicate that there are in fact differences in the reporting practices of key audit matters between the big five audit firms.

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## 6.0 Conclusion

IAASB has adopted new standards for audit reports, ISA 700 (revised) and ISA 701, effective in Norway from December 15<sup>th</sup> 2016. In the audit report, a new section is introduced which addresses the reporting of Key Audit Matters (KAM). This thesis has investigated the differences in the reporting practices of key audit matters between the big five audit firms in Norway.

The reasons why IAASB has introduced a new standard for the audit report is the aspiration to increase the transparency of auditor's work as well as the desire to minimize the expectation-, information-, and communication gaps. The financial statement users have expressed a need for a change in the audit report to increase the insight and understanding of auditor's work. This has resulted in a new standard for the audit report, ISA 700 (revised) and ISA 701.

The most substantial change in the new audit report is the introduction of the section 'Key Audit Matters' (ISA 701). This section deals with the key aspects in the annual report in which the auditor has considered most important in the audit. The auditor is expected to describe the selection of each key audit matter. In addition, the auditor is supposed to describe 'how the matter was addressed in the audit' (Audit Response). A review of the audit, which is influenced by significant estimates and risk of uncertainty in management assessment, will typically be included.

Key audit matters is already implemented in the UK, and the extended UK audit report is similar to ISA 701 in Norway. In order to develop suitable research questions for this thesis, it has been of interest to investigate the reporting of KAM in the UK. In March 2015, The Financial Reporting Council (FRC) published a review of experiences of KAM the first year of implementation in UK. The report contains the main trends and discoveries from a large selection of UK audit reports. There is a global desire to converge audit standards and processes, and thus there are reasons to believe that Norwegian audit reports will resemble the first year reports in the UK. Expectations and research questions of this thesis are based on experiences from the UK, partially influenced by the FRC report.

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The methodology of this thesis consists of a combinational study both including quantitative and qualitative data collections. A review of key audit matters in 137 Norwegian audit reports has been conducted with the intention of finding differences in the reporting of KAM between the big five audit firms. In line with the research questions, five main elements of KAM have been analysed; the number and type of KAMs, the description of KAMs, the description of 'how the matter was addressed in the audit', the use of advanced language, and finally the presentation format of the KAM section. A qualitative data collection supports this combinational study. The qualitative data is carried out by semi structured in-depth interviews, and the respondents consist of certified public accountants from all the big five audit firms in Norway. The purpose of the in-depth interviews has been to detect potential differences in the reporting practices of KAM between the big five audit firms.

The results from this study reveal that there are differences in the reporting practices of key audit matters between the big five audit firms in Norway. The extent of the differences are varying dependent on the element of the KAM section. The type and frequency of KAMs differs to some extent between the big five audit firms, while the description of KAMs, and 'how the matter was addressed in the audit' differs considerably between the audit firms. In terms of the use of advanced language and the presentation format, the reporting practices differ to a relatively small extent between the audit firms.

The communication of key audit matters provides additional information enclosed in the audit report, which proves to involve discretionary interpretations on what to communicate. This thesis detects differences between the big five audit firms in terms of their reporting practices of KAM, most of whom are due to different interpretations of the new standard, ISA 701.

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### *6.1 Limitations of the Study*

There are several limitations present in this thesis. The aim of the study was to investigate the differences in the reporting practices of key audit matters between the big five audit firms in Norway. It has not been of intention to include all audit reports published after December 15<sup>th</sup> 2016. Instead, the selection of audit reports is limited to containing 137 audit reports published from December 31<sup>st</sup> 2016 until April 30<sup>th</sup> 2017. Certain Norwegian audit reports are thus not included in the analysis, which may influence the results. In addition, the collected data from the qualitative part of the analysis is based on our subjective assessments, and cannot be generalized or verified. However, the interviews can explain and support the findings.

Another limitation to this study is that the distribution of analysed audit reports differs between the big five audit firms. The assessment base is hence dissimilar for the audit firms, and the comparison might be somewhat biased. Furthermore, the audit firms have different clients and are present in different industries, which will affect the results.

The range of respondents selected for the qualitative part of the analysis is limited, consisting of one or two certified public accountants from each audit company, in total seven respondents. Their opinions on the implementation and reporting practices of KAM are highly subjective, thus it is impossible to draw conclusions on generalized terms. The validity and reliability of the results obtained from the qualitative analysis can thus be questioned. Further, the interviews resulted in a large amount of information, and the assessment of what is regarded most relevant has also been highly subjective.

Finally, the results can not be generalized to other countries, as the data has been gathered from the big five audit firms in Norway.

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## ***6.2 Suggestions for Future Research***

UK is entering into year four of the utilization of the extended audit report. Several improvements from the first year until now have been identified. The UK auditors seem to have adjusted the identification of what is a key audit matter. It appears that both the section 'key audit matter' and the section 'how the matter was addressed in the audit' have been emphasized in terms of additional information provided (FRC, 2016). A positive development in the reporting of key audit matters is reasonable to expect in Norwegian audit reports as well. Since this master thesis only investigates experiences from the first year of implementation in Norway, and Norwegian audit reports are expected to improve over time, the development will be an interesting area of research.

To perform the same comparative study a couple of years from now to investigate if this leads to different results, could be interesting. Several of the interview respondents predict that the descriptions and formulations of KAM will develop towards increased similarity in the coming years. Auditor reporting awards distributed to 'best practice' reports, such as 'this year's best audit report' from 'DNR-dagen 2017' in Norway, could also result in more universal perceptions on what is regarded 'best' in terms of audit reporting. However, experiences from the UK show that the descriptions of KAMs and 'how the matter was addressed in the audit' have not evolved towards standardized or similar formulations, and that there still exists differences between the audit firms. (FRC, 2016). This could be interesting to further investigate in Norway.

A relevant continuation of this work may be to increase the number of interview respondents. This could entail a more accurate impression of the routines and opinions on KAM of each audit company. To observe auditors at work, either directly by participating in audit assignments, or indirectly by studying the working documents, may also be interesting for this purpose. To conduct an analysis including all the published Norwegian audit reports in 2017, could also be interesting. This would reveal potential differences from the results presented in this thesis. Expanding the survey to apply to more countries, looking at differences and similarities between the big five audit firms in Norway and in comparable countries, is another suggestion for further research.

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Another interesting area of investigation is the intended user's usefulness of key audit matters. IAASB considers investors as the primary users of the companies' financial statements and a major focus has been on designing changes to meet this stakeholder group's needs. Asare & Wright (2012) also emphasizes that the investors are the main users of the audit reports and those who benefit most from it. The interviews with the big five audit firms in Norway revealed expectations of that the reporting of KAM will benefit investors. Whether the investors have embraced the new changes is, however, uncertain. Discussions with various Norwegian portfolio managers indicate that audit reports are barely used in investment decisions. Several managers were not familiar with the implementation of key audit matters in Norway, and did not see themselves benefitting from changes in the audit report. According to the portfolio managers, they only have interest in unexpected information, and since the information in the audit report already is represented in the financial statements, it is regarded as irrelevant. They further suggest that creditors might benefit from the implementation of KAM. However, key audit matters has only recently been implemented in Norway, and it is too early to conclude on its usefulness related to the intended users. Future research in this area would therefore be interesting.

The reporting of KAM in Norway is in its initial phase, and findings from the first year of implementation are not necessarily representative for the coming years. Indeed, findings from the UK showed changes and developments in KAMs and the manner in which these were employed in the four years since the new audit standards were introduced. Perhaps similar developments will be observed in Norway. Many questions have yet to be answered. For instance, will future audit reports include materiality in the KAM section, although this is not required in ISA 701? Interviews with auditors in the big five audit firms in Norway reveal expectations toward more frequent inclusions of materiality in future Norwegian audit reports. Another question is whether audit reports will include findings to a greater extent in the coming years. Different opinions on the accuracy of including findings in the audit report exist between the big five audit companies. Lastly, will the big five audit firms develop their reporting practices on key audit matters beyond what is required through today's audit standard? The developments will be highly interesting to follow.

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The appendix of this thesis has been sent directly to supervisor to protect the sources. The preliminary is attached as a separate file upon submission.