Hong Kong Institute of
Certified Public Accountants
香港會計師公會

October 2017

Standard Setting

Revised Auditor's Reports

First year review of experience

Background

Auditor's reports of listed entities are now required to describe key audit matters (KAMs). This new requirement first applied for financial statements with December 2016 year ends. It aims to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed – for example, in understanding matters that were in the auditor's professional judgement of most significance in risk assessment and conduct of the audit, and in understanding the entity and areas of significant management judgement.

Objectives of our study

The main objectives of this study are to observe how auditors have implemented the new standards and to assess the impact of their requirements. The findings from this report can only give a picture of the first year of implementation. The Institute plans to conduct a similar study next year. With year on year information, the Institute will be able to gain more insights into the challenges and benefits of the new format auditor's report.

Scope of our study

The Institute carried out a review of:

- 423 auditor's reports of entities listed on the Main Board of The Stock Exchange of Hong Kong Limited (the Exchange) and on the Hang Seng Composite Index (HSCI) with December 2016 year ends. The remaining 50 entities on the HSCI have non December year ends and four entities had not published their annual reports at the time of review – we have not studied these auditor's reports. The HSCI offers a comprehensive Hong Kong market benchmark that covers about 95% of the total market capitalisation of companies listed on the Main Board. The HSCI is sub-divided into 11 industry sectors.

- 33 auditor's reports of entities listed on the Growth Enterprise Market (GEM) of the Exchange with December 2016 year ends from the top 25 and bottom 25 market capitalisation. Of the remaining top 25 and bottom 25, 15 do not have December year ends and two annual reports were not available at the time of review.

The auditor's reports and other relevant information were extracted from the annual reports which were available on the HKEXnews between May and July 2017.

The Institute also conducted an online stakeholder survey seeking feedback from practising firms/members, preparers of financial statements and users of financial statements on the benefits and challenges of the first year revised auditor's reports.

Summary of study findings

Table 1a: Range of KAMs reported by Main Board samples by industry sector

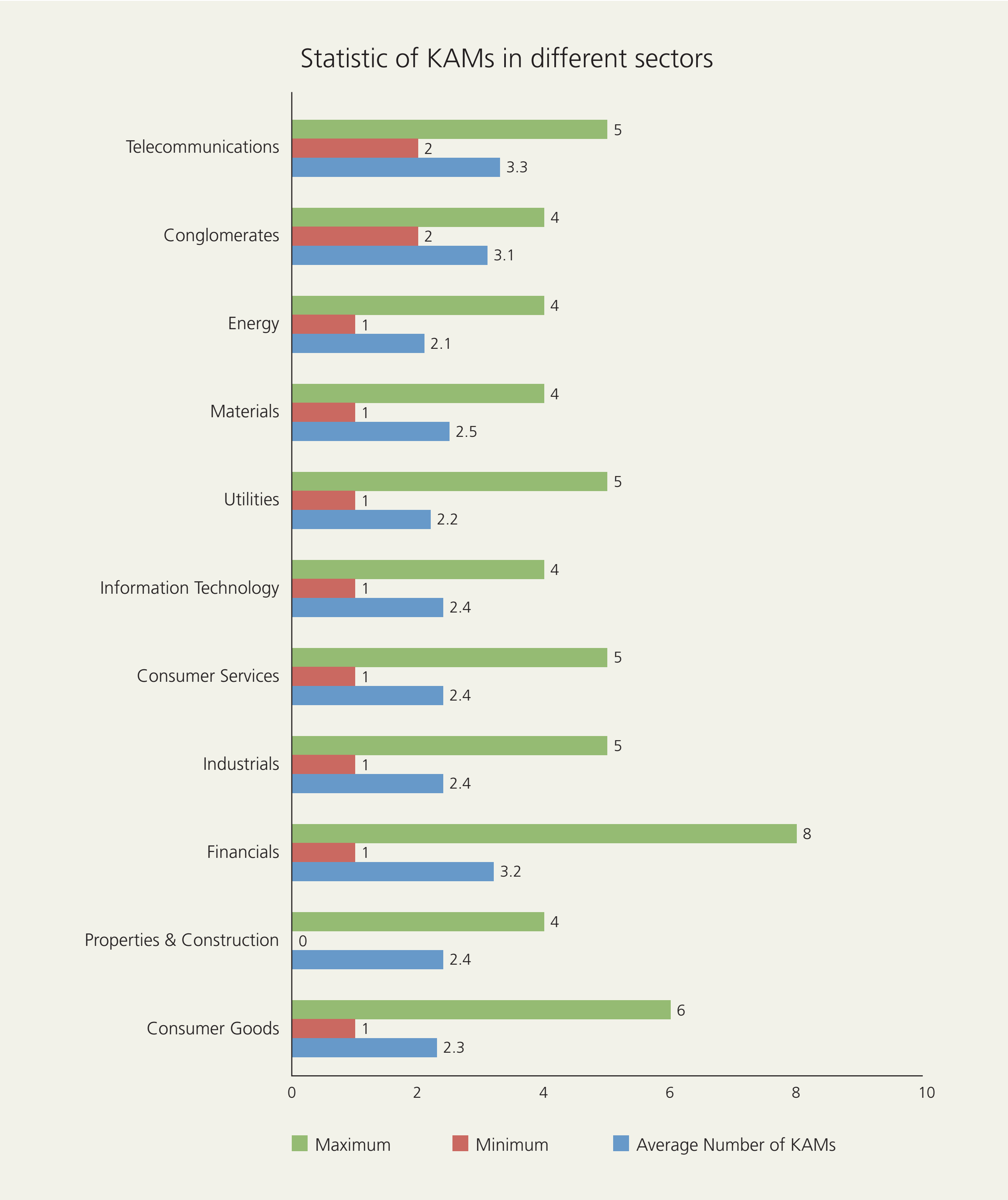
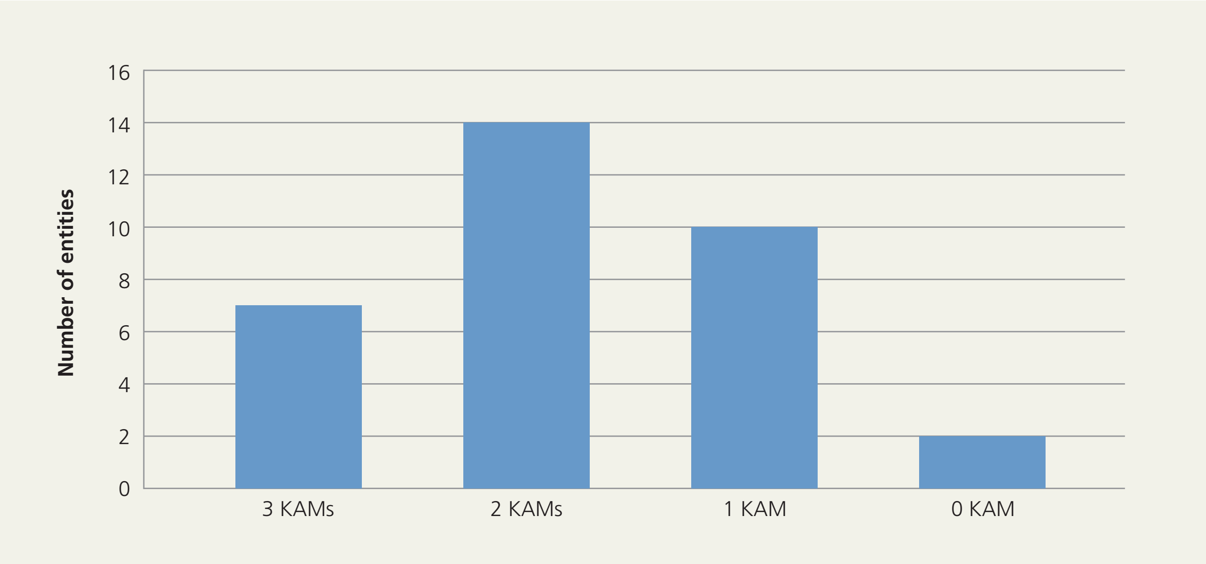


Table 1b: Range of KAMs reported by GEM samples



The average number of KAMs reported by GEM samples is 1.79.

Note: The charts above illustrate the number of KAMs that were reported in the first year of implementation. They should not be regarded as indicative of an appropriate or correct number of KAMs. The key purpose of reporting KAMs is to provide transparency about the areas of a business that were most significant to the auditor, and this may vary year by year, between entities and between industry sectors. Auditors are responsible for determining and reporting KAMs as they see fit.

Observations – Range of KAMs

At least one KAM is reported except when a disclaimer of opinion was issued. No KAM was reported in one case from the Main Board Properties & Construction sector and two cases from GEM because of disclaimers of opinion.

HKSA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report* prohibits the auditor from communicating KAMs when the auditor disclaims an opinion on the financial statements, unless such reporting is required by law or regulation.

Most if not all auditor's reports present the details of KAMs and how they have been addressed side-by-side in a table format.

Table 2a: Analysis of top 15 KAMs for Main Board samples

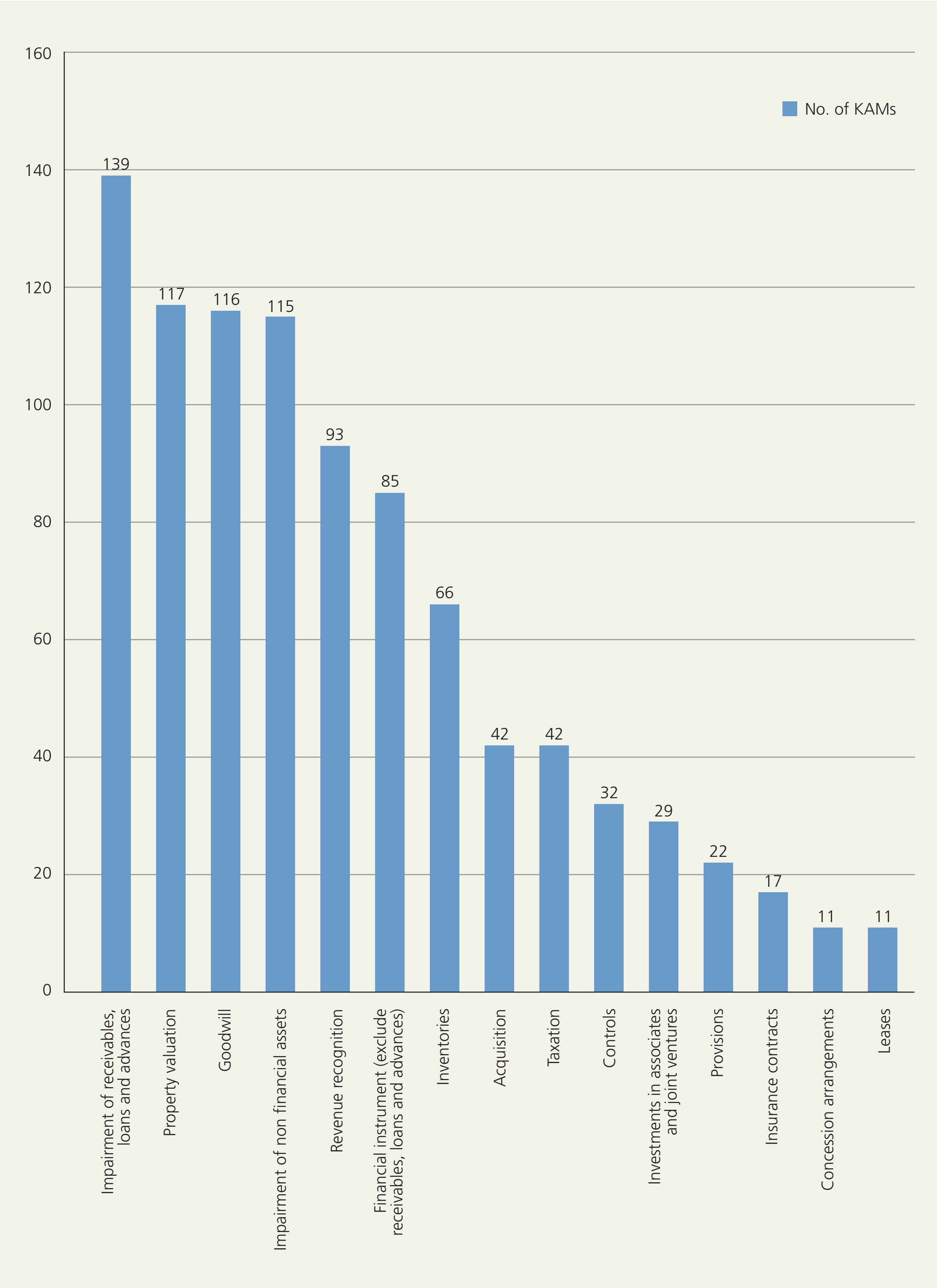
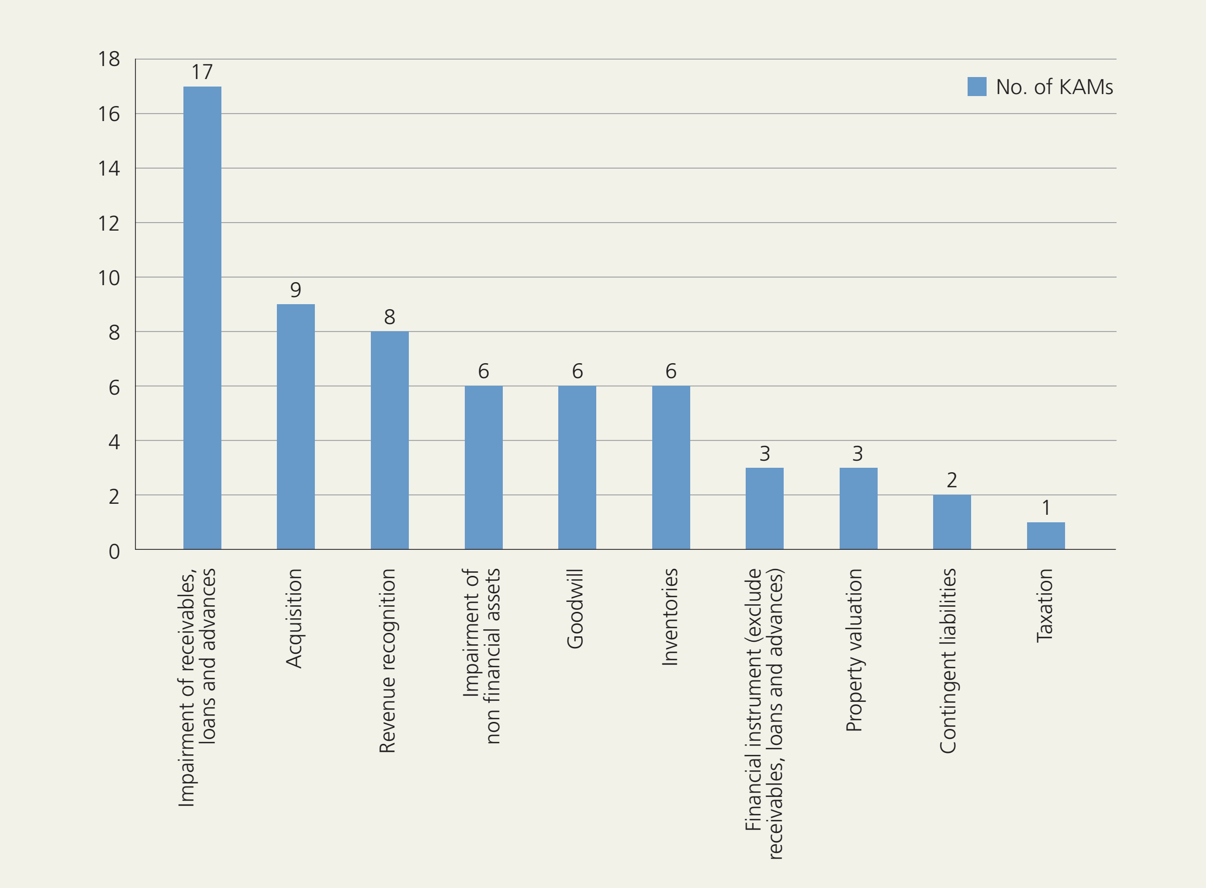


Table 2b: Analysis of KAMs for GEM samples



Note: The charts above illustrate the types of KAMs that were reported in the first year of implementation. They should not be regarded as indicative of the types of KAMs to be reported. The key purpose of reporting KAMs is to provide transparency about the areas of a business that were most significant to the auditor, and this may vary year by year, between entities and between industry sectors. Auditors are responsible for determining and reporting KAMs as they see fit. Auditors should also determine KAMs that are entity-specific.

Observations – Types of KAMs

For Main Board samples, impairment of receivables, property valuation, goodwill, impairment of non financial assets and revenue recognition make up 58% of KAMs. Most sectors have a spread of these KAMs. For the financial sector, financial instruments, impairment of receivables, loans and advances, and controls are common KAMs.

For GEM Board samples, 55% of KAMs relate to receivables, acquisition and revenue recognition.

These KAMs broadly reflect areas that typically involve significant management judgement, and therefore typically require significant auditor attention.

Other observations

The study also looked into other areas of the revised auditor's reports such as going concern disclosures and other information.

Going concern

Seven of the Main Board samples disclosed going concern matters either in a separate section or in KAMs. One disclosed going concern in the "basis for disclaimer of opinion" paragraph.

Two GEM Board samples disclosed going concern matters in a separate section and two in the "basis for disclaimer of opinion" paragraph.

Paragraph 15 of HKSA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* highlights that a material uncertainty related to going concern is, by its nature, a KAM, but would be communicated in a separate required section of the auditor's report in accordance with HKSA 570 (Revised) *Going Concern*.

Nonetheless, the International Auditing and Assurance Standards Board (IAASB) also acknowledged that, in some circumstances, matters relating to going concern (including "close calls") may be determined to be KAMs, in part because this may be a significant or difficult auditor judgement in forming the opinion on the financial statements as a whole. The description of KAMs in the auditor's report relating to going concern could include aspects of the identified events or conditions disclosed in the financial statements, such as substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements, and related mitigating factors.

In situations involving multiple uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate in extremely rare cases to express a disclaimer of opinion instead of including the statements required by paragraph 22 of HKSA 570 (Revised). Paragraph 10 of HKSA 705 (Revised) provides guidance on this issue.

Other information

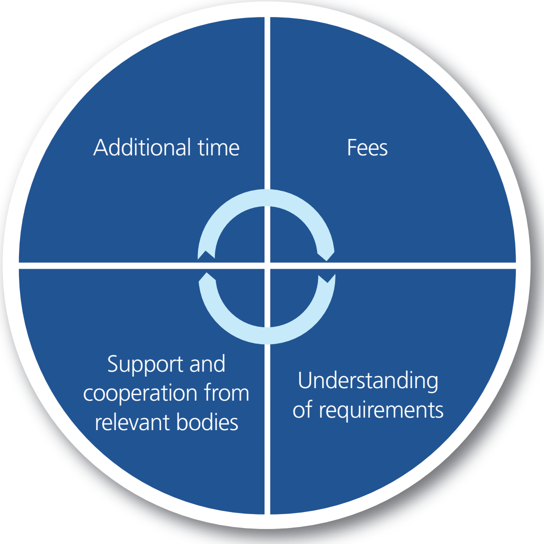
A separate section on "Other Information" is required to be included in all auditor's reports issued under the new standards. This section identifies information that is provided along with the financial statements in an annual report which have or have not been read by the auditors prior to the date of the auditor's report, and reports if there is any material inconsistency.

The auditor's reports of 13 Main Board samples indicated that management had not provided certain information that were included in the annual report prior to the date of the auditor's report. There were no reports of material inconsistency or material misstatements.

The auditor's reports of 29 GEM Board samples indicated that there was no unread outstanding information and no material inconsistency. Two reports had a disclaimer of opinion. Two reports stated that there was insufficient evidence for the auditors to conclude whether the other information was materially misstated with respect to those matters, which gave rise to the modified opinions.

The IAASB aims to commence its post-implementation review on its new and revised standards towards the end of 2017. The IAASB's post-implementation review will specifically seek to understand auditors' and preparers' experience with KAMs and assess the usefulness of communication via the auditor's report about going concern and materiality. Findings from our study will be useful input to the IAASB and the Institute will recommend areas of the standards that need to be clarified.

Observations from our stakeholder survey responses



Auditors are now required to provide greater insights into how they address any significant risk areas pertaining to a company's business. This should add value to a company's shareholders and users of financial statements by giving additional confidence and trust in the operations of a company.

Our analysis of responses from the survey of practitioners, preparers and users indicate the following broad themes:

- Additional time
- Fees
- Understanding of requirements
- Support and co-operation from relevant bodies

Additional time

For a good quality audit, more time is expected for:

- Planning and executing additional communication protocols and reporting deliverables with management and those charged with governance; and

- Discussing with management and those charged with governance additional matters that are likely to require significant auditor attention and, therefore, key audit matters.

From our survey, we found that auditors have incurred additional time, mostly to draft a more detailed and carefully written audit report and to communicate in more depth with those charged with governance.

Responses to our survey indicated that some preparers may still not fully understand the objective of including KAMs in an auditor's report. Preparers have a tendency to compare with peers and "negotiate" with auditors on the number of KAMs to be reported and how much detail is included in the auditor's report. The Institute does not support this practice as it does not meet the aims of the new standards. Auditors are responsible for determining and reporting KAMs as they see fit, regardless of industry or market practice.

Fees

Audit fees are a discussion between an auditor and its clients. The survey indicates that there has been a wide variation in the way audit fees have been affected in the first year of implementing the new auditing requirements. The Institute will continue to study the impact of the new requirements on added time spent, added value provided and fees.

Understanding of requirements

Investors in general found the revised auditor's report to be a step in the right direction for enhancing the value-add work of an auditor. Some auditors and preparers also believe that the revised auditor's report now assists management and investors in having higher quality discussions, for example, regarding risks.

However, from our survey, we have found that investors, preparers and some practitioners still need to be educated on the aims of the new requirements. Continuous education for the profession and all stakeholders is therefore needed to ensure all parties fully understand the new audit requirements. In particular:

- with experience gained from the first year of implementation, auditors need to build on their communication protocols with clients to ensure a smooth audit process. Auditors also need to learn how to apply judgement on what could be a KAM and what could be improved in its communication through the auditor's report.

- preparers may not fully understand that auditors are responsible for determining and reporting KAMs from the matters communicated with those charged with governance. From our survey, we found that there is a misconception that management and those charged with governance are allowed to influence the number of KAMs and determine what types of KAMs to be reported. Whilst it is useful to have a robust two-way dialogue between auditors and those charged with governance about what KAMs were identified and provide those charged with governance an opportunity to obtain further clarification where necessary, the determination of KAMs is solely the auditor's responsibility.

- investors may not fully understand that KAMs are based on the results of the audit on historical financial statements and are not intended to provide insights into other matters such as corporate governance matters or forward-looking information. Communicating KAMs is in the context of an auditor having formed an opinion on the financial statements as a whole. Communicating KAMs is also not about divulging company secrets. The guidance in paragraph A34 of HKSA 701 states that the nature and extent of information provided by the auditor is intended to be balanced in the context of the responsibilities of the respective parties (i.e. for the auditor to provide useful information in a concise and understandable form, while not inappropriately being the provider of original information about the entity).

Support and co-operation from relevant bodies

In the interest of maintaining Hong Kong's relevance as an international financial centre, regulators of auditors, listed companies and directors; standard setters; accounting firms; and professional bodies should cooperate to ensure that the revised auditor's report achieves its intended objectives. Ideally, regulations for corporate governance, corporate reporting and auditor reporting should be considered together to create greater transparency about the judgements made by management and auditors in the course of preparing and auditing financial statements.

The Institute will use its findings from the first year experience to facilitate education efforts for all stakeholders and cooperation among relevant bodies.

Outreach activities

Leading up to the effective date of the new requirements, the Institute conducted the following activities:

- To prepare practitioners, preparers and other stakeholders for the change in the auditor's report, the Institute organized various seminars as well as topical sessions at various conferences.
- To raise awareness of the new and revised requirements of the auditing standards, the Institute's APlus magazine in May, October and December 2015 included educational pieces on the requirements.
- The Institute also had the opportunity to jointly organize events such as a roundtable discussion and interview with The Chamber of Hong Kong Listed Companies.

In the coming year, the Institute plans to reach out and work closely with other regulators and professional bodies to support auditors, preparers and users of financial statements in understanding and implementing the requirements of the new standards more effectively. The Institute will continue to study and survey the effects of applying the new requirements to assess improvement areas and further needs. Findings from this study and future information gathering activities will be shared with IAASB and other national standard setters.

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