A look at the first year implementation of the new auditor's report in Mainland China

Len Jui and **Jessie Wong** observe the initial days of the new regime in China and beyond

The Ministry of Finance of the People's Republic of China approved the issuance of sweeping proposals in December 2016 including a brand-new Chinese Standard on Auditing (CSA) and substantial revisions to six other existing CSAs written by Chinese Institute of Certified Public Accountants (CICPA), to change the way in which auditors report on the audit they conduct on the financial statements of their audit clients. These changes became effective on 1 January 2017 and are aligned with international developments in this area led by the International Auditing and Assurance Standards Board. Ever since China achieved convergence with International Standards on Auditing (ISAs) in 2010, maintaining this convergence remains the top priority of the Chinese auditing profession.

The role of, and the value brought about by, the external audit in supporting the quality of financial reporting globally, whether in the context of the capital markets, the public sector or the private or non-public sector, are well established. The external audit is widely acknowledged as an essential part of a jurisdiction's regulatory and supervisory infrastructure. A high quality audit is also an important pillar of a company's corporate governance.

Response to users' call for change

These new changes to the auditor's report are some of the most widespread and significant that the auditing profession has seen over the last 30 years. Following the global financial crisis of 2007-2008, investors questioned the value of audits when audit reports failed to provide early warning signals of financial weakness for subsequent corporate collapses. The Financial Stability Board expressed that the recent global financial crisis has demonstrated the importance of addressing the contribution of external audit to financial stability. Fueled by the crisis, users of financial statements and the auditor's report, called for improvements to be made to the communicative value of the auditor's report beyond the auditor's conclusions. It is clear that the standard audit report no longer fulfil the needs of the capital market. Changes are needed quickly so audits can continue to be of value to users including investors, companies and regulators.

A differentiator of audit quality

Governments, regulators, shareholders, investors, lenders and other creditors, as well as those charged with governance are all users of the auditor's report. Although each of these stakeholder groups use the reports in differing ways, they nevertheless are interested in maintaining the usefulness of the auditor's report. Even though the auditor's report is the main channel for auditors to communicate the result and findings of the audit, it remains difficult to differentiate a high quality audit from a low quality one. Currently, audit fees are often the key measure upon which decisions regarding auditor selection and retention are based. These have led to inadvertent consequences such as low-balling of fees, which has concerned regulators regarding the impact on audit quality. Users of the auditor's report have also questioned whether there is sufficient transparency in regard to the audit performed. Addressing these concerns are at the heart of the changes proposed to the auditor's report.

With enhanced information content, each auditor report will provide information specifically tailored to the audited entity. This is a stark change from the current standard boilerplate auditor's report. Users of the auditor's report will use the new information in different ways to meet their objectives. For all, however, these customized disclosures by the auditor will provide more meaningful insights into the audit thereby enabling users of the auditor's report to better assess the work performed by the auditors. As CICPA Secretary General, Chen Yugui, commented "the new auditor's reports provide an assessment of the level of professionalism of the audit profession, and similarly that of individual audit firms."

Implementation of the new auditor's report

Starting 1 January, the first phase of the implementation of the new auditor's report commenced in Mainland China. For this first reporting period under the new auditor's reporting regime, by 4 September a total of 119 new auditor's reports have been issued. These consist of the following: (i) 95 A+H shares companies of which 90 of these companies are listed on the Main Board and five are listed on the Small Medium Enterprise Board, collectively these companies accounted for a total market capitalization of RMB16,069 billion; (ii) 20 H shares companies whose audits are performed in accordance with CSAs; and (iii) four

Mainland companies that adopted the new auditor's report early on a voluntary basis.

The new auditor's reports covered Mainland companies across a diverse range of sectors including industrials, financials, energy, information technology, telecommunication services, utilities, healthcare, real estate, materials, and consumer discretionary/consumer staples. The industrial and financial sectors accounted for the highest number of new auditor's reports issued.

The new auditor's reports were issued by a total of 12 Mainland China firms, namely, Baker Tilly China, BDO China, Daxin, Deloitte Touche Tohmatsu, Ernst & Young Hua Ming, Grant Thornton China, KPMG Huazhen, Pan-China, PricewaterhouseCoopers Zhong Tian, Ruihua, ShineWing and DaHua. Of these firms, PricewaterhouseCoopers Zhong Tian, Ernst & Young Hua Ming, ShineWing, Deloitte Touche Tohmatsu and KPMG Huazhen accounted for 75 percent of all new auditor's reports.

New auditor's report format

The new auditor's reports present a new format with the audit opinion presented before the auditor's report as this is the most important piece of information to users of the report. The auditors also make a declaration of their independence and fulfillment of ethical responsibilities as required by the CSAs and the CICPA Code of Ethics for Professional Accountants. For the A+H shares companies, 93 auditor's reports issued had clean opinions, one auditor's report included emphasis of matter and one auditor's report issued disclaimer of opinion.

In the new auditor's report, management and auditor's responsibilities regarding assessing and determining the audited entities' going concern are more clearly described. In addition, the auditor is now also required to disclose if there is material uncertainty regarding the entity's going concern. Such disclosures had been observed in two of the new reports. The new report also better describe the auditor's responsibilities and key features of an audit including any work that the auditor does regarding the information in the annual report outside of the audited financial statements. The auditor is now also required to disclose if there is material misstatement regarding such information. Such disclosures had not been observed in any of the auditor's reports issued.

The auditor's report is no longer a standard two-page report. For the A+H shares companies, the length of the new auditor's reports range from three to 13 pages; representing an increase of between 50 percent and 550 percent in report length as compared to the previous two-page report.

Key audit matters disclosures

As it is now required to disclose Key Audit Matters (KAMs) in the new auditor's report if the auditor determines there are no KAMs to communicate, then the auditor is required by the CSAs to include a statement to this effect. Except for the one auditor's report with disclaimer of opinion, all the remaining 94 new auditor's reports issued reported KAMs for the audits performed. The number of KAMs reported ranged from one to five. The CSAs states that determining which, and how many, KAMs to report is a matter of the auditor's professional judgment, and may be affected by the size and complexity of the audited entity, the nature of its business and environment, and the facts and circumstances of the audit engagement.

As anticipated, as a diverse range of industry sectors are covered by the new auditor's reports, the type of KAMs reported are wide-ranging. For the A+H share companies, the most commonly observed areas addressed by the KAMs related to impairment of inventories, non-current assets and available-for-sale financial assets, revenue recognition, business combinations and long-term equity investments. These accounted for nearly 75 percent of the KAMs reported. The high number of KAMs relating to impairment of inventories, non-current assets and available-for-sale financial assets may be due to high proportion of industrial (including transportation and capital goods and commercial services and supplies) and financial sectors-related companies in the population of A+H share companies. It was also observed that over 75 percent of the A+H shares companies in the industrial and financial sectors reported KAMs relating to business combinations and long-term equity investments.

Other areas addressed by the KAMs included fair value measurement, liabilities and contingent liabilities and intangible assets.

Observations of the implementation of the new auditor's report in other jurisdictions

Australia, New Zealand, Hong Kong and Singapore started implementation of the new auditor's report for audits of financial statements for periods ending on or after 15 December 2016. However, as the new auditor reporting requirements were issued in these jurisdictions in advance in 2016 by the local audit standard-setters, a number of companies and their auditors were early adopters of the new auditor reporting regime. The number of such early new auditor's reports in these four jurisdictions ranged between five to 20.

In Australia and New Zealand, the length of the early new auditor's report ranged from three pages to a high of 10 pages. The number KAMs ranged from one to seven, with the most common being three. Similar to what is being observed with the KAMs for Mainland entities, the nature of the KAMs reported were wide ranging with some commonalities in the areas valuation of goodwill and intangibles, revenue recognition, acquisitions and taxation.

In Hong Kong, the number of KAMs in the early new auditor's reports ranged from two to five, and all of the early new auditor's reports addressed valuation as a KAM. It was observed that for all of these entities, the same KAMs were being reported in the following year.

In Singapore, early new auditor's reports covered a range of industry sectors including real estate, telecommunications, shipping, transport and logistics, investment management and funds, and banking and financial services. The length of the early new auditor's reports ranged from four to nine pages. The number of KAMs reported in these early new auditor's reports ranged from two to six, and the most commonly reported area being asset valuation.

Worthy of mention is that for these four jurisdictions, the auditing standards permit the auditors choice in location of the description of the auditor's responsibilities

Auditors and audited entities have to implement the new auditor's report changes according to the following timetable announced by the Ministry of Finance:

From 1 January 2017: New Auditor's Report (including disclosure of Key Audit Matters)
• Mainland companies listed in both Mainland China and Hong Kong (A+H shares companies) whose auditor's reports are for use in Mainland China
• A+H shares companies whose audits are performed in accordance with CSAs and auditor's reports are for use outside Mainland China
• Mainland companies listed in Hong Kong (H shares companies) whose audits are performed in accordance with CSAs
2018: New Auditor's Report (including disclosure of Key Audit Matters)
• Mainland-listed companies (companies listed on the Main Board, the Small Medium Enterprise Board and the Growth Enterprise Board of Shanghai and Shenzhen Stock Exchanges)
• Initial Public Offerings
• Companies with public bond offerings
• Unlisted public companies belonging to the Innovation Tier whose shares are publicly transferred on the National Equities Exchange and Quotation (NEEQ) System (New Third Board listed companies)
(Exempt from disclosure of Key Audit Matters) • All other audits performed in accordance with CSAs

which account for roughly about a page in the new auditor's report. The options being within the body of the auditor's report, with an appendix to the auditor's report or by specific reference in the auditor's report to the location of such description on a website of the local audit standard setter. Despite the availability of these options, it was observed that the large majority of the auditors who issued these early new auditor's reports choose to retain the description in the body of the auditor's report.

Conclusion

The audit profession heralds this new regime in auditor reporting as a new chapter in the profession's development and a significant step in ensuring continuing relevance of the audit. The standard auditor's report will be replaced by a user-needs driven, entity-specific expanded auditor's report. Users of the auditor's report can now look forward to being better informed about the audit process and receiving relevant disclosures from auditors regarding the audit work done and findings of the audit. It is hoped that the new auditor's report can encourage enhanced communications between the investors and the auditors. In the event enhanced disclosures are provided by the entity, similarly, this may also encourage engagement by investors with management and those charged with governance on accounting and auditing matters.

The changes are also anticipated to lead to enhanced communications between the auditors, those charged with governance and the audit committees, in particular, communications relating to the identification of KAMs. The new disclosures by the auditors will likely also lead to increased attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report, thereby enhancing the quality of financial reporting.

In Mainland China, as it is in other jurisdictions around the globe that have embraced the new auditor's report, it is early days in the implementation of this new regime. The benefits of these enhancements can only be realized through collaboration between stakeholders groups. Failed implementation by the auditing profession and unwillingness by users to embrace the new auditor's report will result in large costs and implementation difficulties. Successful implementation by auditors and active uptake by users, however, will give a much-needed boost to the meaning and value of the audit.

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