

First year experiences with revised auditor's reports

Since December 2016 auditor's reports of listed entities are required to describe key audit matters (KAMs), enhancing the communicative value of the report to shareholders and other interested parties.

The Hong Kong Institute of CPAs carried out a review of 423 auditor's reports of Main Board entities and 33 reports from the Growth Enterprise Market (GEM) of The Stock Exchange of Hong Kong Limited. Samples were taken from entities on the Hang Seng Composite Index which represent 95 percent of market capitalization while the entities from the GEM represent the 25 largest and 25 smallest companies by market capitalization – of which 33 had reports available at time of review.

Range of KAMs reported

At least one KAM is reported by auditors except when a disclaimer of opinion is issued. Hong Kong Standard on Auditing (HKSA) 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report* forbids the auditor from communicating KAMs when the auditor disclaims an opinion on the financial statements, unless required by law or regulation. The majority of auditor's reports present the KAMs and how they have been addressed in a table.

The number of KAMs reported by Main Board entities ranged from zero to eight and the average number reported was

between two and three (*see diagram 1*). The average number of KAMs reported was 1.8 for GEM samples (*see diagram 2*).

Types of KAMs reported

For Main Board samples, impairment of receivables, property valuation, goodwill, impairment of non-financial assets, and revenue recognition make up 58 percent of KAMs reported (*see diagram 3*).

For GEM samples, 55 percent of KAMs related to impairment of receivables, acquisition, and revenue recognition (*see diagram 4*).

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

Other observations

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

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 a KAM by its nature, but would be communicated in a separate section of the auditor's report in accordance with HKSA

570 (Revised) *Going Concern*. Nonetheless, the International Auditing and Assurance Standards Board acknowledged that sometimes matters relating to going concern (including "close calls") may be KAMs, in part because there may be a significant or difficult auditor judgement required in forming their opinion.

In extremely rare cases, where there are multiple uncertainties significant to the financial statements, the auditor may express a disclaimer of opinion rather than including the statements required. Guidance can be found in Paragraph 10 of HKSA 705 (Revised).

A separate section on "Other Information" is required to be included in the auditor's report. This section identifies the accompanying information provided with the financial statements in an annual report and reports on any material inconsistency. In the study 13 Main Board samples indicated that management had not provided certain information prior to the date of the auditor's report. There were no reports of material inconsistency or material misstatements.

For GEM samples, two reports had a disclaimer of opinion and two stated that there was insufficient evidence for the auditors to conclude whether the supplementary information was materially misstated.

Diagram 1 KAMs reported by Main Board samples by industry sector

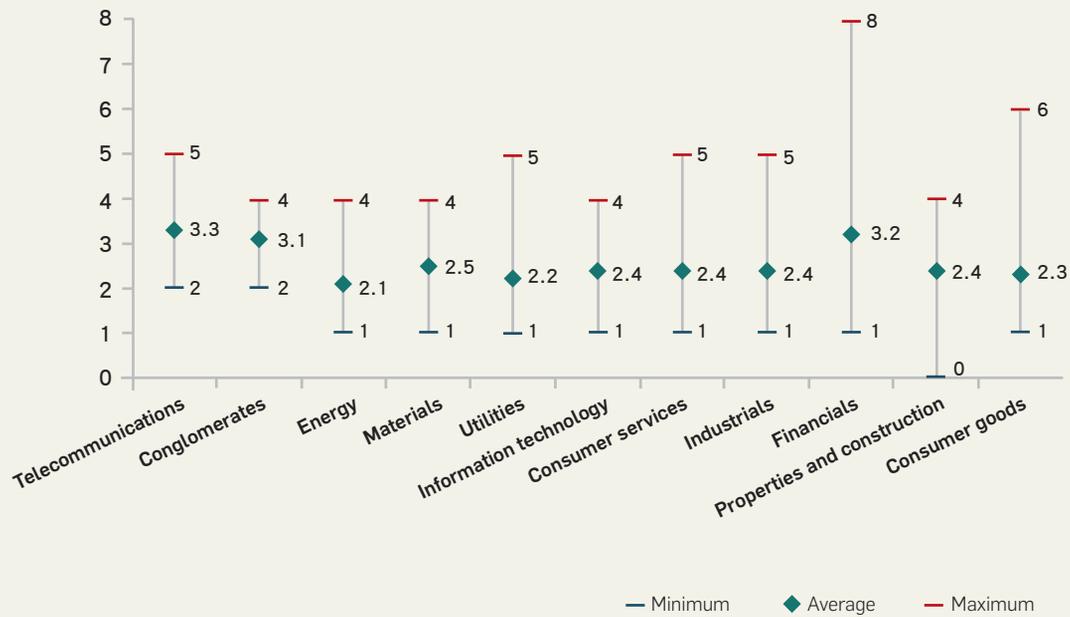
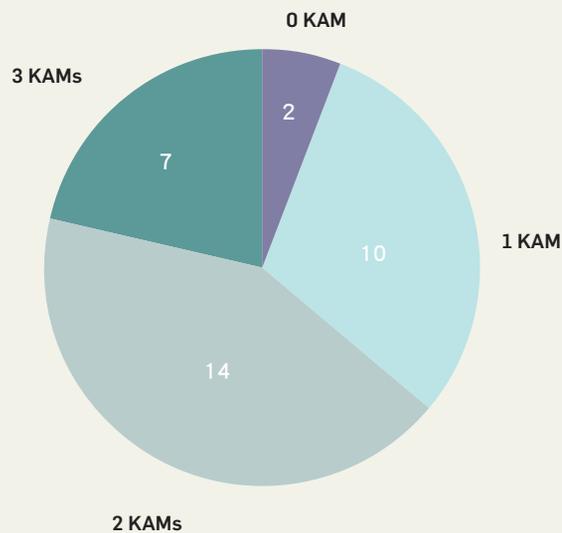


Diagram 2 KAMs reported by GEM samples



Note: The charts illustrate the number and type of KAMs reported by the entities sampled. They should not be regarded as indicative of an appropriate or correct number or types 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 entity-specific KAMs as they see fit.

Diagram 3

Top 10 KAMs reported by Main Board samples

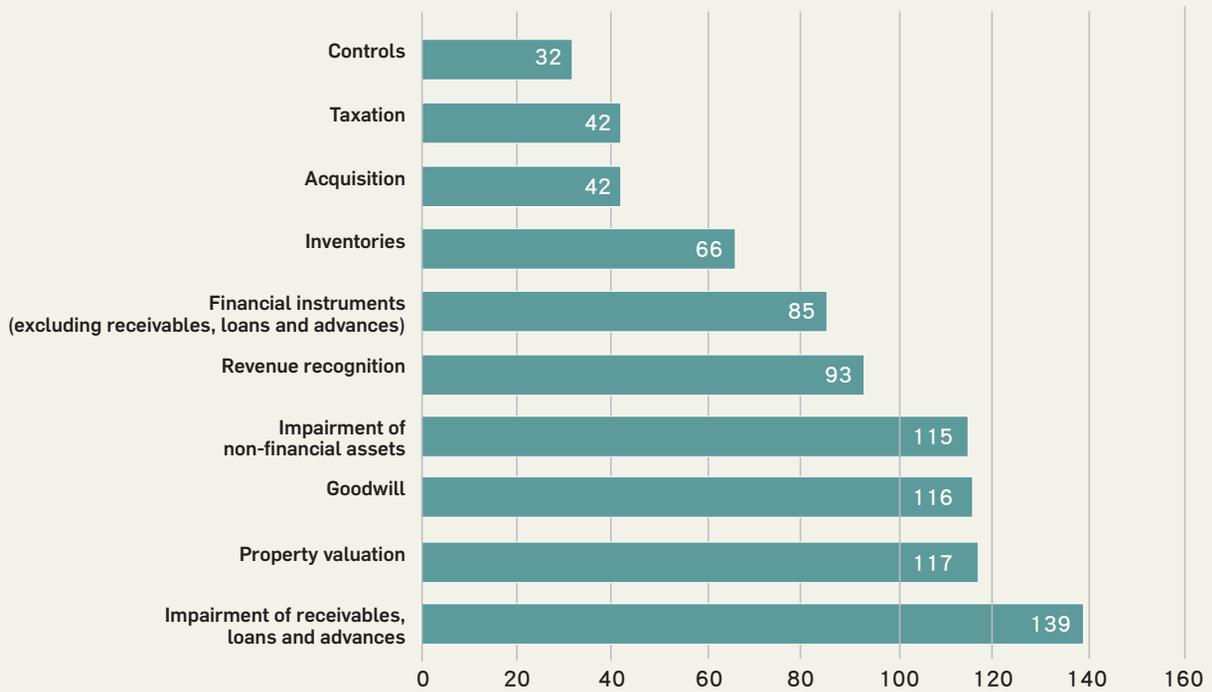
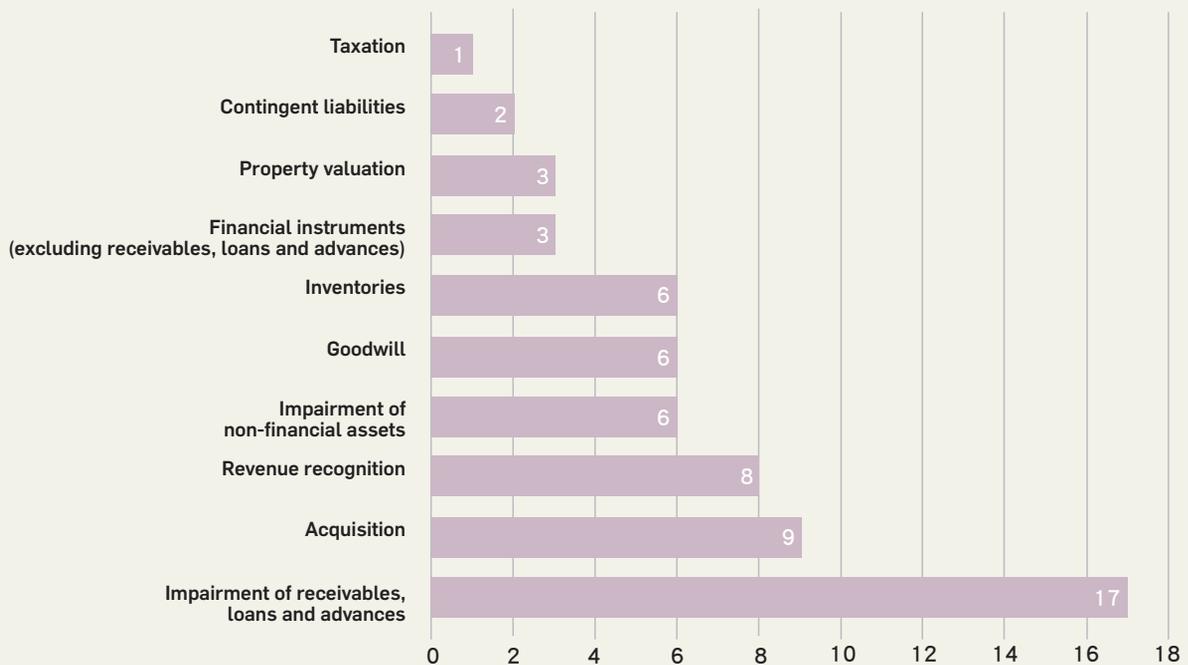


Diagram 4

Types of KAMs reported by GEM samples



Stakeholder survey

The Institute's analysis of responses from the survey of practitioners, preparers and users indicate four broad themes related to the implementation of the revised auditor's reports.

Additional time

The survey found that the revised auditor's reports take longer to draft as they are more detailed and carefully written audit reports and require greater levels of communication with the company.

Responses to the survey indicated that some preparers may still not fully understand the objective of including KAMs in an auditor's report. Instead, they have a tendency to compare with peers and "negotiate" the number of KAMs to be reported and how much detail is included. 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.

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 implementation. 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 that the revised auditor's report to be a step in the right direction for enhancing the value added 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, the survey 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:

- Auditors need to build on their communication protocols with clients for a smooth audit. Auditors also need to learn how to apply judgement on what could be a KAM and improve communication through the auditor's report.
- Preparers must understand that auditors are responsible for determining and reporting KAMs from the matters communicated with those charged with governance. There is a misconception amongst respondents that the management and those charged with governance are allowed to influence the number and types of KAMs reported. Whilst it is useful to have a robust two-way dialogue between auditors and those charged with governance, providing those charged with governance an opportunity to obtain further clarifications, 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 or forward-looking information. Communicating KAMs is in the context of an auditor having formed an opinion on the financial statements

as a whole and not about divulging a company's secrets.

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 improve transparency about the judgements made by management and auditors in the preparation and auditing of financial statements.

The Institute will use these findings to facilitate education efforts for all stakeholders and cooperation among relevant bodies. 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 will also be shared internationally.

The full report can be read at:
<http://ow.ly/T1sM30gAyba>



This article is contributed by the Institute's Standard Setting Department.