

Second year experiences with revised auditor's reports

Auditors have had to report key audit matters (KAMs) of listed companies since December 2016. This enhances auditor's reporting by communicating with stakeholders matters of the most significance in the auditor's professional judgement. This report, from the Institute's Standard Setting Department, is the second year review of this new style of reporting. In our first study, the Institute concentrated our study on the types of KAMs reported in the first year of implementation. For this second study, we added an analysis of the qualitative aspect of KAMs to understand the effects on users of financial reports, gain more insights into the areas of improvements and benefits, and determine how the profession could better respond to stakeholders' needs.

For this report we analysed 429 auditor's reports of Hang Seng Composite Index (HSCI) and 50 reports from the Growth Enterprise Market (GEM) of the Stock Exchange of Hong Kong Limited.

Key statistics

Similar to our study in 2017, reports disclosed at least one KAM but not more than eight, except one company in the Properties and Construction sector (where the auditor issued a disclaimer of opinion and did not report any KAMs). Companies with the highest number of KAMs reported were 8 KAMs for HSCI companies and 6 KAMs for GEM companies. 96 percent of HSCI company reports analysed and 94 percent of GEM companies disclosed between one and four KAMs.

Compared with the first year, there was no significant difference in the average number of KAMs overall. The average for HSCI companies in 2016 reports was 2.5 while in 2017 reports average was 2.4 – a marginal decline. The number is unchanged for entities from the GEM, where the average remained at 1.8 (see diagram 1).

Our study found that 46 percent of HSCI companies examined had the same nature and number of KAMs reported as in our first study, while 43 percent had

partially or completely different KAMs.

The most common types of KAMs reported were similar to our first study, upon which impairment of receivables, loans and advances and goodwill remained the most commonly identified KAMs across many industries. The top KAMs for each board samples are illustrated in diagrams 2 and 3.

We also found that the most commonly reported KAM types are also commonly noted as KAMs in auditor's reports from other jurisdictions, which indicates that auditors worldwide were identifying similar topics as KAMs during their audits.

In-depth review

We selected a number of auditor's reports and KAMs for in-depth review, analysing four main areas:

Number of audit procedures reported

Our review noted that on average, 4.0 audit procedures per KAM were reported for HSCI companies and 3.6 for GEM companies. Diagram 4 shows the numbers of audit procedures performed per KAM.

Reporting style

We observed that a majority (76 percent) of the audit reports used bullet points to describe audit work performed while the remaining applied paragraphing.

Describing the outcome of auditor's procedures

Although auditors are not required to describe the outcome of their procedures performed, paragraph A51 of Hong Kong Standard on Auditing (HKSA) 701 *Communicating Key Audit Matters in the Independent Auditor's Report* states that auditors may provide an indication of the outcome of the auditor's response in the description of the KAM in the auditor's report. We found a number of descriptions, including the following examples:

"We consider the management conclusion to be consistent with available information."

"Based on the work performed, we

found the Group's revenue from sales of goods being tested were recognized in a manner consistent with the Group's revenue recognition accounting policy."

"Based on the results of our procedures, we found management's assessment of occurrence of impairment and the models and inputs used for determining the impairment losses was acceptable."

"We found that the assumptions made by the management in relation to the value in use calculations to be reasonable based on available evidence."

Feedback from users

The Institute's study supplemented by feedback collected from members of the profession and investor community including financial reporting and audit regulators, equity researchers and corporate governance consultants, provided comment on the quality of disclosure. Throughout this report these survey respondents are referred to as users. Analysis of the feedback covered two broad themes:

Why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM

In general, users view the reporting of KAM favourably as it provides enhanced information about significant accounting and audit issues of the company and how they were dealt within the audit, which is useful to their analysis of the company.

A common response from users was that most KAMs used generic description and standardized language which did not provide sufficient insight into the reported KAMs and nature of audit work performed. This is demonstrated in the example below:

Impairment assessment of trade and other receivables

"In determining whether there is objective evidence of impairment loss, the Group takes into consideration the credit history of the customers and the current market condition which may require management judgment."

Diagram 1 KAMs reported by Main Board entities by sector 2017 & 2016 average

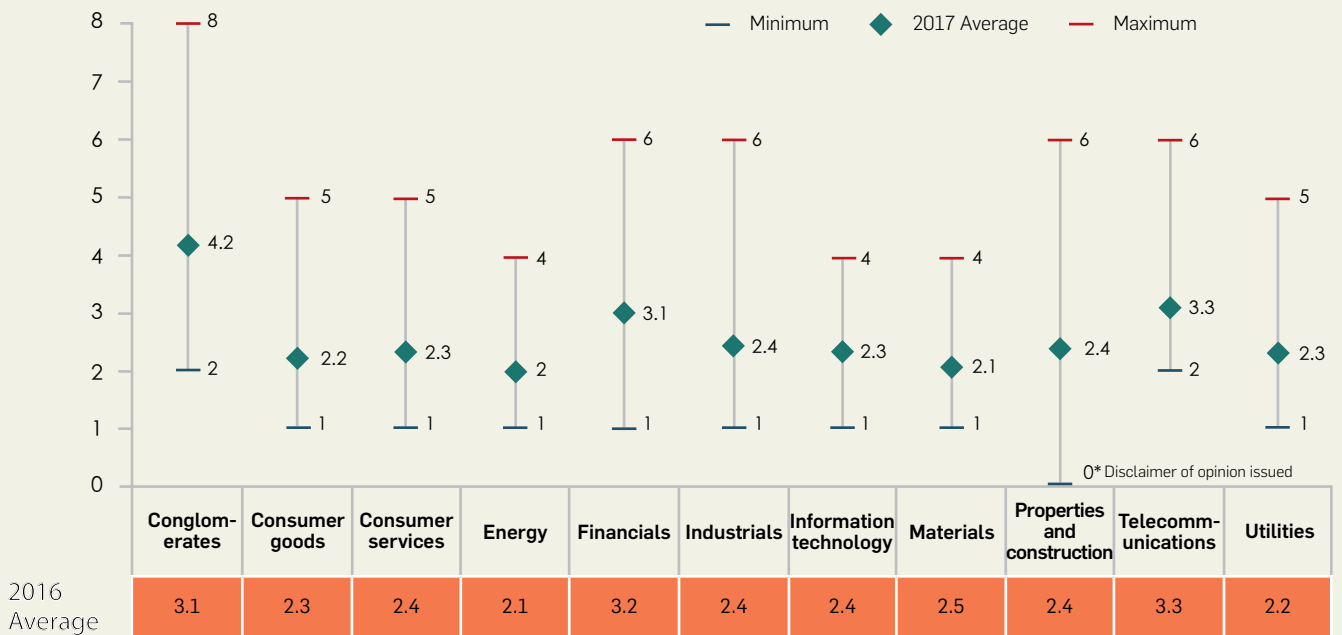


Diagram 2 Comparison of top 10 KAMs reported by Main Board samples

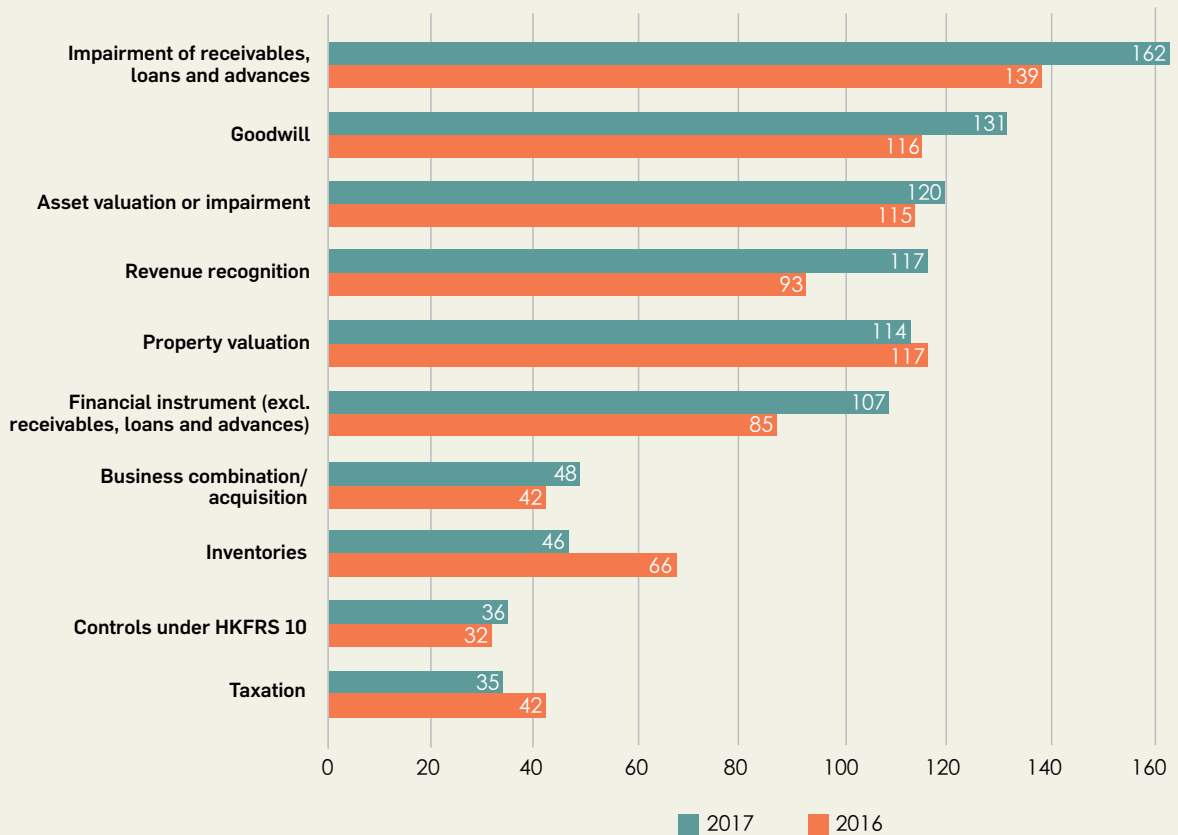


Diagram 3

Comparison of top KAMs by GEM samples

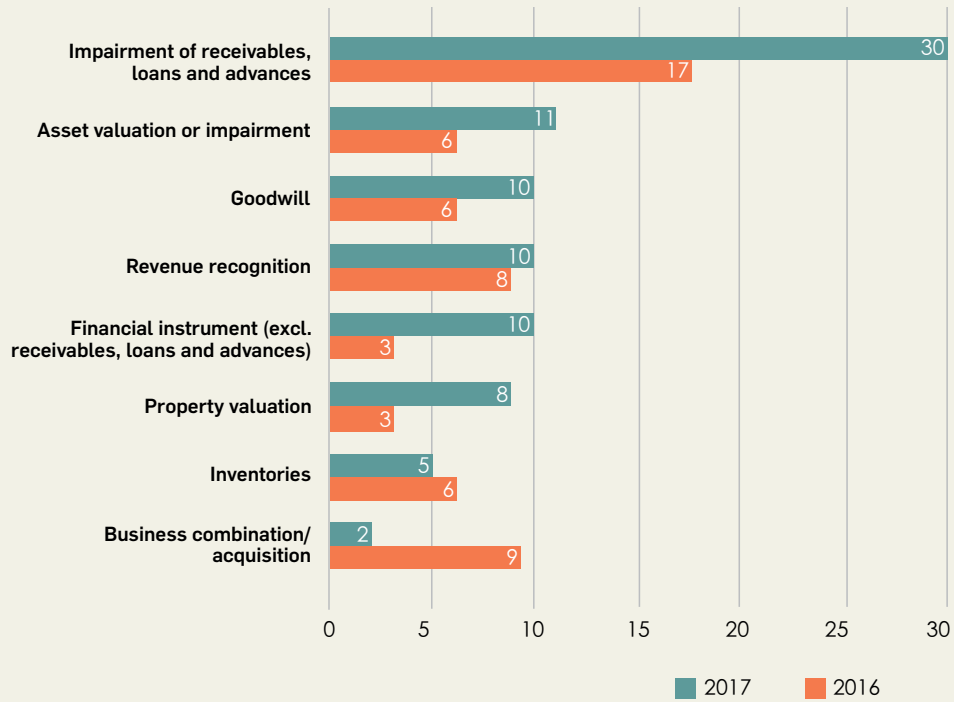
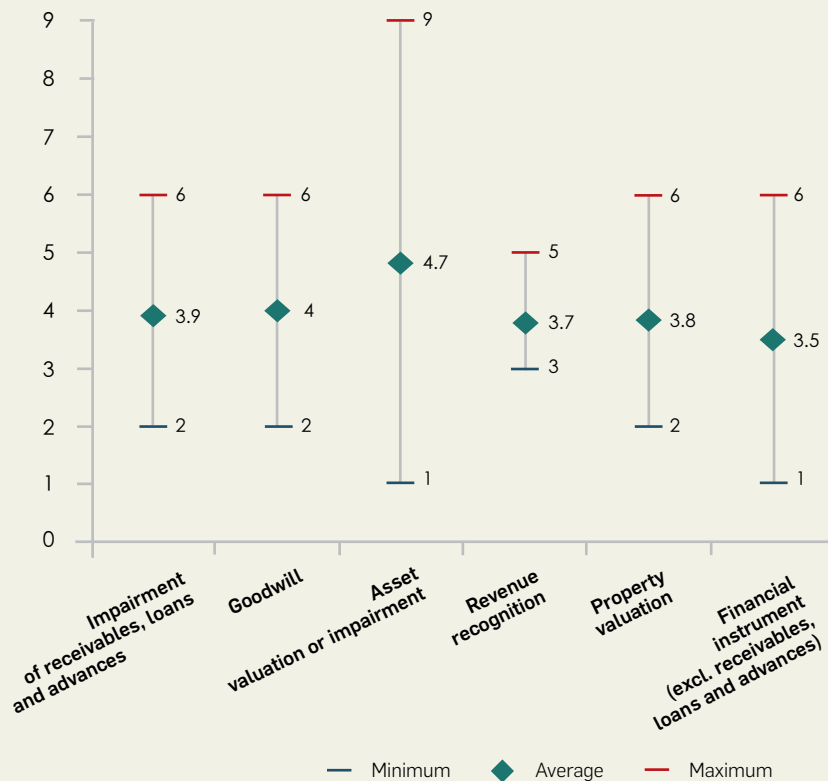


Diagram 4

Number of audit procedures reported, 2017



Some KAMs identified did not include sufficient descriptions of the reasons the auditor determined the issue to be a KAM. They only mentioned issues involving management judgement or described management's assessment process. Below is an example of a KAM identified with insufficient description:

Impairment assessment of trade receivables

"Assessing impairment of trade receivables is a subjective area as it requires the management's judgement and uses of estimates. We have identified impairment assessment of trade receivable as a key audit matter."

Paragraph A34 of HKSA 701 states that the description of a KAM is intended to provide a succinct and balanced explanation to enable intended users to understand why the matter was one of most significant identified, and how the matter was addressed in the audit. This corresponds to one user's remark that the granularity of a KAM description enhances the auditor's transparency.

How the matter was addressed in the audit

From the feedback, we discovered that the description of KAMs in some samples was clear and concise but with little insight into how the audit procedures were performed. The example below demonstrates this:

Impairment assessment of goodwill and intangible assets

"Our audit procedures in relation to management's impairment assessment included:

- *Evaluated the methodology used by the Group in performing impairment assessment;*
- *Challenged the reasonableness of key assumptions based on our knowledge of the business and industry; and*
- *Reconciled input data to supporting evidence, such as latest financial forecasts approved by the management and considering the reasonableness of these forecasts."*

In certain samples, audit procedures

were simply listed without sufficient information on how the audit work eased concern about the KAMs. When procedures performed were not adequately described, the description of outcome was regarded as unhelpful. The majority of users would like to see how audit procedures had been altered to the entity's specific circumstances and better understand how each KAM has been satisfactorily addressed.

Paragraph A46 of HKSA 701 says that the amount of detail to be provided in the auditor's report to describe how a KAM was addressed in the audit is a matter of professional judgement. The auditor may describe:

- Aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement,
- A brief overview of procedures performed,
- An indication of the outcome of the auditor's procedures, or
- Key observations with respect to the matter, or some combination of these elements.

Relatedly, one user commented that the limited explanation of audit procedures performed, led the user to question if sufficient audit work was performed by the auditor. This is illustrated in the example below:

Impairment assessment of goodwill

"Our main procedures in relation to the impairment assessment of goodwill included:

- *Assessing management's determination of the Group's cash-generating units based on our understanding of the nature of the business and the economic environment in which the cash-generating units operate.*
- *Based on our knowledge of the business and industry, challenging the reasonableness of the underlying key assumptions and data used in the cash flow forecasts (including revenue growth rate, operating profit, and discount rate used.)*

Based on our procedures described, we found the estimations of management in relation to

goodwill is supported by plausible evidence."

Although it is not a mandatory requirement of the standard, generally users value enhanced disclosures of outcomes of audit procedures performed, preferring greater transparency about the auditor's view on the appropriateness of management estimates.

Conclusion

From the study of second year reports, we saw benefits in the enhanced auditor reporting format but there is still room for improvement in order to achieve the objective of improving the auditor's report's communicative value. Auditors are recommended to strike a balance between reporting granular, entity-specific KAM and providing an appropriate level of information that does not go beyond those disclosed by management in the annual report.

The Institute will continue to monitor the qualitative aspects with year on year information to provide deeper insights on how the profession could better respond to stakeholders' needs.

The full report can be read at:
bit.ly/2ndYearAR



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