STANDARD SETTING

SECOND YEAR REVIEW OF ENHANCED AUDITOR'S REPORTS

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

Executive Summary

The reporting of key audit matters ("KAMs"), which became effective for listed entities on 15 December 2016, marks a new era of auditor's reporting by communicating with stakeholders matters of the most significance in the auditor's professional judgement. The Hong Kong Institute of Certified Public Accountant ("Institute") is keen to understand the effects this new style of auditor's reporting has had on users of financial reports and determine how the profession could better respond to stakeholders' needs in relation to the reporting KAMs.

In last year's report[1], we analysed the types of KAMs reported in the first year of implementation. This year, we added an analysis of the qualitative aspect of KAMs in order to gain more insights into the areas of improvements and benefits of the revised format auditor's report. We reviewed a selection of auditor's reports of companies listed on the Hong Kong Stock Exchange and obtained feedback from the financial reporting and audit regulators and the investor community on the qualitative aspect of selected KAMs. We thank those who have generously shared their views with us.

The key findings from our review this year include:

- Statistically, the majority of companies disclosed 2 or 3 KAMs with a shift towards reporting 2 KAMs compared with last year.

- In general, the reporting of KAM is viewed favourably by users as it provides enhanced information about significant accounting and audit issues of the company and how they were dealt with in the audit. It also enhances auditors' interaction with preparers, management and those charged with governance ("TCWG"). As a result, management and TCWG have gained deeper insight on the financial reporting of their companies and therefore strived improvements in annual report disclosures.

- A common feedback from users participating in our study this year was that most KAMs reviewed used standardised language which did not provide sufficient insight into the reported KAMs and nature of audit work performed. This could be enhanced by linking the KAM and the specific audit work performed, although it is challenging for auditors to strike a balance between the granularity of KAM description and writing a clear and concise description of the key audit procedures.

- Users are generally in favour of auditors including an indication of the outcome of the audit procedures performed in respect of each KAM. They noted that this provided them with more transparency and insight. These outcome descriptions are not required by Hong Kong Standard on Auditing (HKSA) 701 *Communicating Key Audit Matters in the Independence Auditor's Report*, but may be provided so long as auditor does not give the impression that the description is conveying a separate opinion on an individual KAM.

We hope this report provides insights on how the profession could better respond to stakeholders' needs.

November 2018

Highlights of key statistics

Our study covered 479 auditor's reports from companies included in the Hang Seng Composite Index ("HSCI") or the Growth Enterprise Market ("GEM") Exchange, which reported 1,134 total KAMs.

Number of KAMs	Reports in our sample disclosed at least one KAM but not more than eight. 96% and 94% of auditor's reports of the HSCI companies and GEM companies, respectively, disclosed one to four KAMs. These statistics are similar to our study last year.
Average number of KAMs	The average number of KAMs was 2.4 for HSCI companies and 1.8 for GEM companies. No industry sector has a significantly different average number of reported KAMs compared to our study last year.
No. of companies reporting KAMs differently from prior year	46% of covered HSCI companies had the same nature and number of KAMs reported as last year, while 43% had partially or completely different KAMs from last year.
Number of KAMs	The following KAM types constitute 73% KAMs covered by our analysis: - Impairment of receivables, loans and advances; - Goodwill; - Asset valuation or impairment (excludes goodwill, investment properties, properties held for sale and financial instruments); - Revenue recognition; - Property valuation; and - Financial instruments (excludes receivables, loans and advances). These types are also frequently reported as KAMs for companies in other jurisdictions[(2)].

1. Summary of study findings

1.1 Scope of our study

We analysed the auditor's reports of 479 companies with published annual reports for the year ended 31 December 2017. This comprised 429 companies listed on the HSCI and from the GEM, the 25 companies with the highest market capitalization and the 25 companies with the lowest market capitalization as of 30 May 2018.

The auditor's reports and other relevant information were extracted from the companies' annual reports which were available on the HKEXnews website between May and August 2018.

Figure 1: Analysis of reviewed auditor's reports by audit firm

	HSCI companies	GEM companies
Big 4	371	14
Other audit firms	33	35
Audit firms practising outside Hong Kong	25	1
	429	**50**

1.2 Number of KAMs

The majority of companies in our sample disclosed either 2 KAMs (41% for HSCI companies and 42% for GEM companies) or 3 KAMs (26% for HSCI companies and 15% for GEM companies). Only 14% HSCI and 4% GEM companies had 4 or more KAMs.

On average, the auditor's reports in our population disclosed 2.4 KAMs (2016: 2.5 KAMs) for HSCI companies and 1.8 KAMs (2016: 1.8 KAMs) for GEM companies.

On a year-to-year comparison, more companies in the study who reported 3 KAMs last year (2017: 25%; 2016: 32%) were reporting 2 KAMs this year (2017: 41%; 2016: 36%).

Companies with the highest number of KAMs reported were 8 KAMs for HSCI companies and 6 KAMs for GEM companies.

A couple of reports studied did not have KAM section as the auditors expressed:

- a qualified opinion and the auditor had determined that there were no other KAMs to report except the matters described in the basis for qualified opinion section; or

- a disclaimer 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.

Figure 2: Number of KAMs reported by HSCI samples

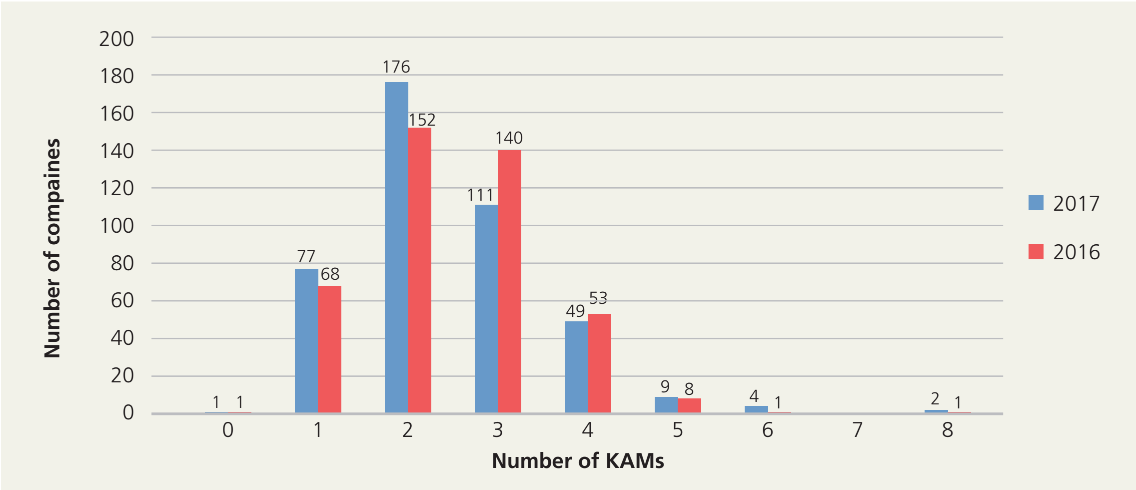


Figure 3: Number of KAMs reported by GEM samples

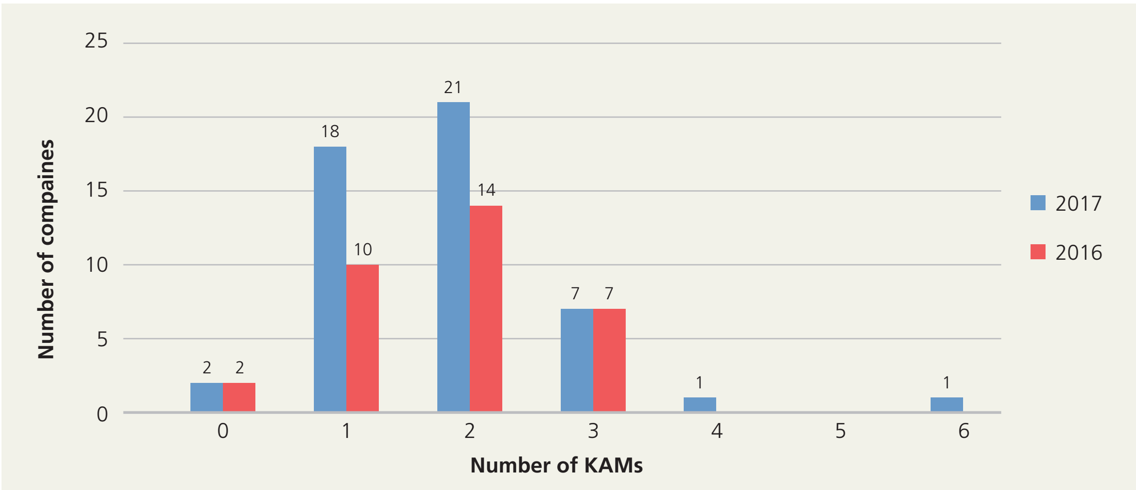


Figure 4 sets out the number of KAMs by industry sector. We also compared the number of KAMs reported by this year and last year. The results indicate that there has been no significant increase or decrease overall or by industry sector.

Figure 4: Number of reported KAMs by industry sector

HSCI Industry sector[(a)] / GEM companies	No. of companies 2017	No. of KAMs 2017				No. of companies 2016	No. of avg. KAMs 2016
		Total	Min.	Max.	Avg.		
Conglomerates	9	38	2	8	4.2	8	3.1
Consumer Goods	93	202	1	5	2.2	92	2.3
Consumer Services	42	96	1	5	2.3	43	2.4
Energy	15	30	1	4	2.0	15	2.1
Financials	52	162	1	6	3.1	51	3.2
Industrials	47	113	1	6	2.4	48	2.4
Information Technology	34	78	1	4	2.3	33	2.4
Materials	21	45	1	4	2.1	19	2.5
Properties & Construction	78	186	0[(b)]	6	2.4	78	2.4
Telecommunications	7	23	2	6	3.3	7	3.3
Utilities	31	70	1	5	2.3	30	2.2
2017	**429**	**1,043**	**0**	**8**	**2.4**		
2016	**424**	**1,058**	**0**	**8**	**2.5**		
GEM companies	50	91	0[(b)]	6	1.8	3.3	1.8

Note:

(a) Industry sector categorization is based on HSCI categories

(b) The auditor issued a disclaimer opinion and did not report any KAM

What does the standard say?

HKSA 705 (Revised) 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.
(Extract from paragraph 5 of HKSA 701)

The auditor shall not communicate a matter in the KAMs section of the auditor's report when the auditor would be required to modify the opinion in accordance with HKSA 705 (Revised) as a result of the matter.
(Extract from paragraph 12 of HKSA 701)

The determination of KAMs involves making a judgment about the relative importance of matters that required significant auditor attention. Therefore, it may be rare that the auditor of a complete set of general purpose financial statements of a listed entity would not determine at least one KAM from the matters communicated with those charged with governance to be communicated in the auditor's report. However, in certain limited circumstances (e.g., for a listed entity that has very limited operations), the auditor may determine that there are no KAMs because there are no matters that required significant auditor attention.
(Extract from paragraph A59 of HKSA 701)

1.3 How KAMs were reported differently from last year

2017 was the second year of the new style of auditor's reports. Amongst the HSCI companies we analysed, 46% had the same type and number of KAMs reported as last year. 43% companies had KAMs either partially or completely changed from those of last year; most of the changes related to business combinations and asset valuation or impairment; some were on the potential impact of adopting Hong Kong Financial Reporting Standard (HKFRS) 9 *Financial Instruments* which became effective on 1 January 2018.

For companies which reported the same type and number of KAMs in both years, our analysis noted that:

- mostly had no change or only minor changes in the description of KAMs; and
- nearly all of them had the same number and type of audit procedures reported in the second year of the enhanced requirements.

1.4 What KAMs were reported

Figure 5 summarises the top types of KAM in the reports we analysed.

Figure 5a: Analysis of top 15 KAM types for HSCI companies

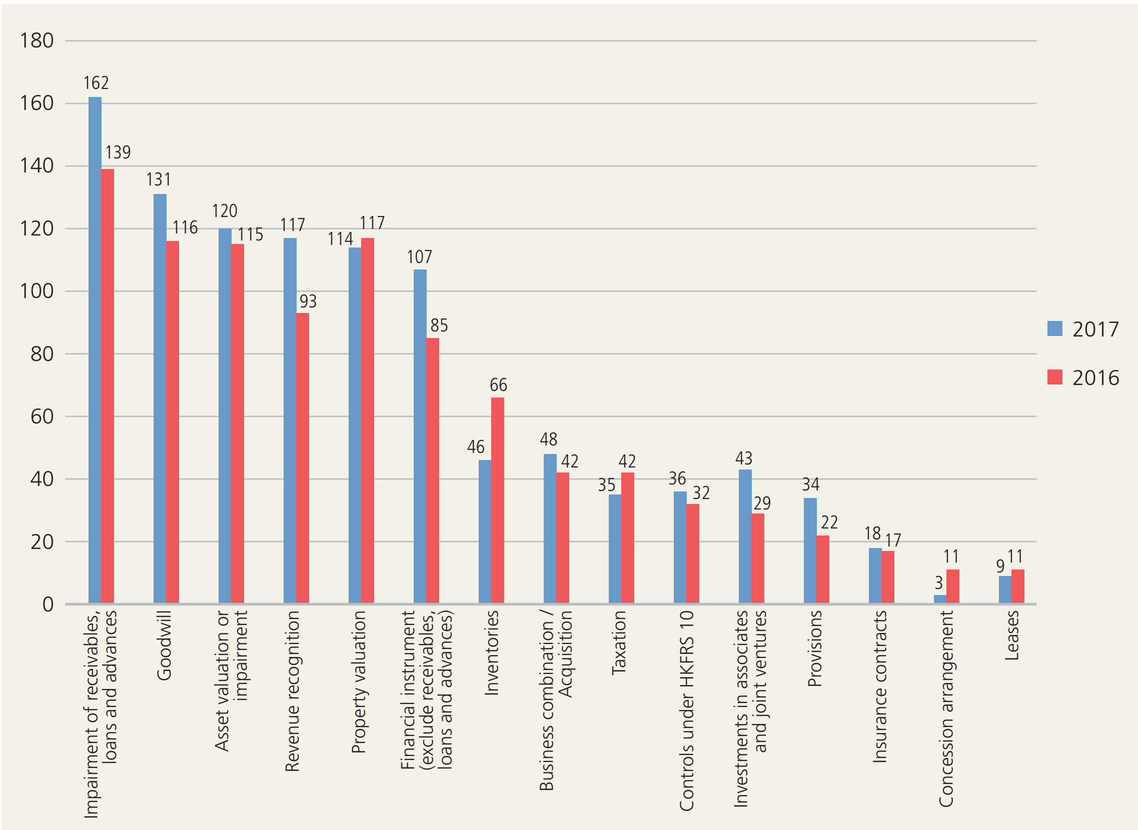
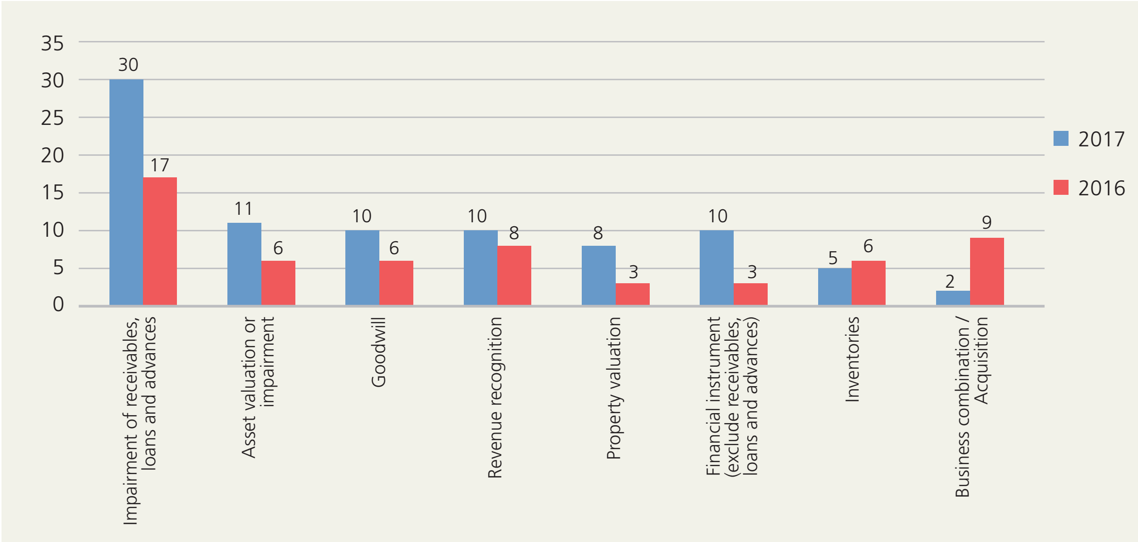


Figure 5b: Analysis of KAMs for GEM companies



The 15 highest ranked KAM types[(3)] for HSCI companies comprise 98.1% of the total number of KAMs in the sample analysed.

The most common types reported were similar to last year's study. Two of the top types identified, namely impairment of receivables, loans and advances and goodwill, were reported as KAMs across many industries.

Other common types were more frequently reported in some industries or transactions, which suggested specific risks prevailing in particular sectors such as:

- 73% companies in the Energy sector had KAMs on asset valuation or impairment mainly due to the volatile oil prices.

- Revenue recognition was more frequently reported as KAM in the Telecommunications and Information Technology sectors due to the volume of transactions, complexity of system, variety of tariff and package structures and complexity of multi-element arrangements.

- 84% companies in the Properties and Contruction sector had KAMs on property valuation related issue, due to significant management judgements and assumptions involved in the valuation of investment and development properties and their relative signifiance to the company's total assets.

- 87% companies in the Financials sector had KAMs on financial instruments related issues, particularly on valuation and impairment. A couple of financial institutions had KAMs on the potential impact of adopting *HKFRS 9 Financial Instruments* which came into effect on 1 January 2018.

It is worth noting that top ranked KAM types identified in our analysis are also commonly noted as KAMs in auditor's reports from other jurisdictions[(2)]; it indicates that auditors worldwide were identifying similar topics as KAMs.

2. In-depth review of selected KAMs

We selected a number of auditor's reports and KAMs to be reviewed in detail. Our approach to sampling focused on the most frequently reported KAMs identified in Figure 5, and included reports from all audit firms identified in the study except for reports by non-Hong Kong practicing auditors who are not CPA firms or corporate practices registered with the Institute. In total there were 73 KAMs selected for in-depth review.

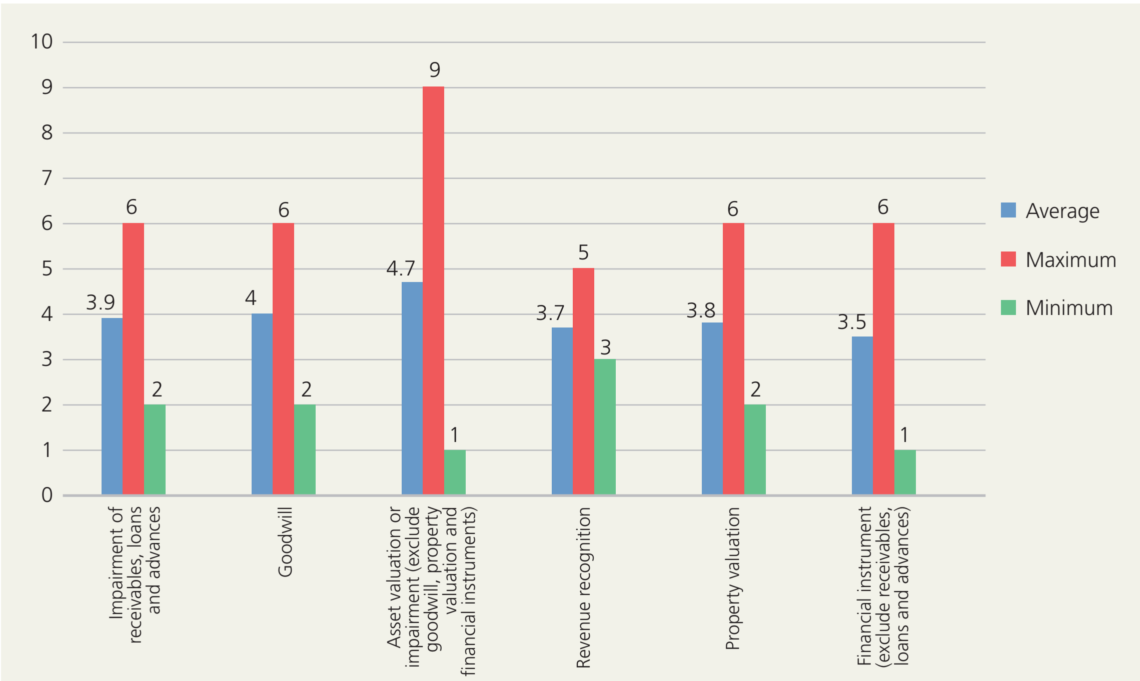
The in-depth review involved analysing the following:

- number of audit procedures reported;
- reporting style;
- describing the outcome of auditor's procedures; and
- feedback from users.

2.1 Number of audit procedures reported

Our study noted that on average, 4.0 audit procedures per KAM were reported for HSCI companies and 3.6 for GEM companies. The number of audit procedures reported for top KAM types are set out in Figure 6.

Figure 6: Number of audit procedures reported



2.2 Reporting style

In describing audit work performed, 76% of sampled audit reports were structured using bullet points while the remaining 24% applied paragraphing. In general, one bullet point or paragraph was applied for one audit procedure performed.

We observed one audit firm which, in most of its reports, described all audit procedures performed in one paragraph without subdivision. This made the report difficult to read.

2.3 Describing the outcome of auditor's procedures

Whilst not required by the standard, we observed that some audit firms described the outcome of audit procedures performed in the reports.

Figure 7: Description of the outcome of audit procedures we have seen

"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 recognised 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."

What does the standard say?
Communicating KAMs in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating KAMs in the auditor's report is not a separate opinion on individual matters
(Extract from paragraph 4(d) of HKSA 701)

The auditor may also provide an indication of the outcome of the auditor's response in the description of the KAM in the auditor's report. However, if this is done, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual KAM or that in any way may call into question the auditor's opinion on the financial statements as a whole.
(Extract from paragraph A51 of HKSA 701)

2.4 Feedback from users

Our study was supplemented by feedback collected from individuals from the profession and investor community ("users"). They include financial reporting and audit regulators, equity researchers, corporate governance consultants who are experienced in financial statements analysis but in different capacities to preparers and auditors, and who may not necessarily be well versed in KAM reporting requirements and other considerations under the auditing standards. Each of the users was given a list of KAM samples reported by different audit firms to comment on the quality of disclosure, in particular, whether the reported KAM:

- sufficiently explained what affected the auditor's judgement that led the matter to be a KAM;
- sufficiently explained why the KAM required significant auditor judgement;
- provided sufficient insight into the risk;
- provided sufficient information about the audit work as to how the risk was dealt with;
- influenced users' views / decisions about the reported company; and
- provided useful information.

The users reviewed the samples selected for the further analysis as set out above. It should be noted that views described in this section are solely those of the users participated in this study and do not necessarily represent views of the profession and investor community.

What does the standard say?
The description of each KAM in the KAMs section of auditor's report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

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

(b) How the matter was addressed in the audit.

(Extract from paragraph 13 of HKSA 701)

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

Overall, users found the new audit reporting useful to their analysis of the company. Revised reports represent an improvement from the previous reporting requirement which only provided a binary clean or modified opinion.

Users were able to find enhanced information about significant accounting and audit issues of the company and how they were dealt with in audits, without going through the lengthy details in the annual report.

Most users considered the majority of KAMs used generic description, standardised language and were not specific to the company's situation; more could be provided to link the issue and audit work performed to the company's specific circumstance. One user considered one of the samples as "a copy of the professional standard with no assessment and explanation of auditor's judgement/conclusion". Refer to Figure 8 for two examples.

Figure 8: Extract of KAMs with generic language

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."

Impairment assessment of available-for-sale investments
"The Group recognizes impairment for available-for-sale investments in consolidated statement of profit or loss and other comprehensive income when there is objective evidence of impairment, which includes when there has been a significant or prolonged decline in the fair value of the investments. The impairment recognized in the consolidated statement of profit or loss and other comprehensive income is the cumulative difference between cost and fair value. The impairment assessment for available-for-sale investments is significant and determination of whether there is objective evidence of impairment involves significant management judgment."

One user suggested that an entity-specific KAM should provide insight on how the business model of the company gives rise to the associated risk. It is expected that auditors have sufficient understanding of their clients and corresponding industries to provide such description. One user stated that the granularity of a KAM description enhances the auditor's transparency.

Some KAMs explained why the issue warranted significant auditor's judgement which made auditor's "thought process" more evident to users. However, some samples only mentioned the issue involved management judgement or described management's assessment process; the reason that auditor determined that this was a KAM was not evident. This is illustrated in Figure 9.

Figure 9: Extract of KAM with insufficient description of the issue

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 receivables as a key audit matter."

What does the standard say?
Communicating KAMs in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.
(Extract from paragraph 4(a) of HKSA 701)

The adequacy of the description of a KAM is a matter of professional judgment. 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 significance in the audit and how the matter was addressed in the audit. Limiting the use of highly technical auditing terms also helps to enable intended users who do not have a reasonable knowledge of auditing to understand the basis for the auditor's focus on particular matters during the audit. 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).
(Extract from paragraph A34 of HKSA 701)

2.42 How the matter was addressed in the audit

A user found disclosure about the audit work performed informative, but noted that it does not necessarily ease concerns about the risk described in the KAM because users would expect that an auditor cannot completely eradicate the risks by performing audits.

Some samples used concise language to describe the audit work performed and was easy to understand. For instance, a user found the language used in Figure 10 "was clear in explaining the audit work on different types of financial instruments and steps to assess impairment."

Figure 10: Extract of KAM that is clear and concise

> ***Impairment assessment of available-for-sale financial assets***
> *"With respect to available-for-sale debt instruments, we evaluated management's judgement of the occurrence of the impairment event by referring to market data including market price and the credit ratings of the investees.*
>
> *With respect to available-for-sale equity instruments, we evaluated management's judgement of the occurrence of the impairment event by referring to market data including market price or financial information of the investees. We also evaluated the appropriateness of the criterion applied by management in their assessment of whether the decline in fair value was 'significant' or 'prolonged' by reference to market practice.*
>
> *For impaired instruments, we tested the impairment losses made by evaluating the models and inputs used including market price, financial information of the investees and comparable market parameters."*

For samples with specific and granular KAM description, users found themselves in a better position to assess whether the audit work performed was sufficient to address the issue.

Description in some samples gave little insight as to how the audit procedures had been carried out, which concerned users as to whether the audit procedures performed were adequate. This is illustrated in Figure 11.

Figure 11: Extract of KAM with little insight on how the audit procedures were performed

> ***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."*

A user considered some samples "simply listed the audit procedures performed" but did not provide insight or sufficient information on how the audit work eased concern about the KAM; majority of users would like to see how audit procedures had been catered to the entity's specific circumstances which was lacking in the samples they reviewed.

Another user found the audit procedures performed in one sample were "based on auditor's understanding of the business of the entity without performing any other audit work". In another sample, a user found auditor's description of the outcome in some samples unhelpful as limited procedures were described for the KAM. The user went on to question if sufficient audit work was performed. Refer to Figure 12 for illustration.

Figure 12: Extract of KAM where the auditor compared the issue against their understanding as audit procedures

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."

In general, users would like to see auditor's description of outcome on audit procedures performed which provide more transparency and insight about the audit work performed, although it is not required by HKSA 701. Without an indication of outcome, a user might not be able to assess whether the reported KAM was properly dealt with by management. For example, if an auditor assessed the valuation methodology associated with the KAM, but did not provide insight about whether the valuation methodology was reasonable.

What does the standard say?

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 judgment. 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.

(Extract from paragraph A46 of HKSA 701)

3. Comments from the Institute's Auditing and Assurance Standards Committee

The Auditing and Assurance Standards Committee ("AASC") is responsible for the adoption of standards on auditing and assurance by the Institute to achieve convergence with the pronouncements issued by the International Auditing and Assurance Standards Board ("IAASB"). AASC also develops and issues practice notes, auditing and technical bulletins, circulars and discussion papers to provide information and/or guidance to the Institute's members to stimulate debate on important auditing and assurance issues.

The following are comments from AASC on their experience in the second year of implementation:

"The interaction between preparers and TCWG with the auditors have been improved. There is less push back or questions from the preparers / TCWG."

"The audit committee had also gained deeper insight into the audits. In certain instances, the audit committee members requested management to provide further information on the areas covered by KAMs."

"Directors and management had gained deeper insight into financial reporting risks of their companies through their reviews of KAMs, and this resulted in their making improvements to disclosures in the financial statements and other elements in annual reports."

"There were no problems in communicating with management the KAMs we identified. The identified KAMs were accepted by management though, in certain instances, they had concerns as how much details (such as specific audit procedures) should be included in describing a KAM."

"Auditors need to strike a balance between reporting granular, entity-specific KAM and providing appropriate level of information not beyond those disclosed by management in the annual report. This is a key challenge for auditors in complying with the standard requirements while focusing on users' needs which may be beyond the requirements of the standard."

"Though auditors may not expect KAMs to change much for stable business environment, auditors would need to be aware of subtle changes that their clients experience year on year and consider their effect on KAMs."

Way Forward

To conclude the key takeaways from this year's study include:

- The implementation of KAMs and this new format of auditor's report is a good first step in providing enhanced information about significant accounting and audit issues of the company and how they were dealt with in the audit (i.e. makes the information more understandable).
- KAMs act as indicators and guide users to the key focus areas whereby further information can be obtained from the financial statements.
- Benefits to users could be enhanced:
  - ➢ with more granular information on the matter which would improve the transparency level on the work of auditors, and
  - ➢ more industry specific information or insights.

The Institute will continue to monitor the qualitative aspects of KAMs and expect to see auditor's reports contain KAMs which are useful to users. The Institute will work with practitioners to help them provide value-added auditor's reports.

(1) The Institute's publication "Revised Auditor's Reports First year review" in October 2017 summarised findings on how auditors have implemented the new standards of revised auditor's reporting. The report is available at: http://www.hkicpa.org.hk/file/media/section6_standards/standards/Audit-n-assurance/kamrp1017.pdf

(2) References were made including but not limited to the following publications:

- Extended auditor's reports - A further review of experience *(The Financial Reporting Council Limited)*
- A first year review of the enhanced auditor's reports in Singapore *(Accounting and Corporate Regulatory Authority, Association of Chartered Certified Accountants (ACCA), Institute of Singapore Chartered Accountants and Nanyang Technological University)*
- A review of first-year implementation experience in Malaysia *(Securities Commission Malaysia and Malaysian Institute of Accountants and ACCA)*
- Key audit matters – A stock take of the first year in New Zealand *(External Reporting Board and Financial Markets Authority of New Zealand)*

(3) This report illustrates number of KAMs that were reported in the initial two years of the requirements. 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.

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Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East, Wanchai, Hong Kong
Tel: (852) 2287 7228
Fax: (852) 2865 6603
Email: hkicpa@hkicpa.org.hk
Website: www.hkicpa.org.hk

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