

Research on the Prevention and Response of Goodwill Impairment Auditing Risk Based on the Audit Case of Zeus Entertainment

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Abstract: The impact of goodwill on financial statements has attracted attention from all walks of life. The huge impairment of goodwill in A-shares at the end of 2018 made goodwill once again the focus of discussion and research. The uncertainty of accounting estimates for the subsequent measurement of goodwill and the complexity of the impairment testing process have long brought greater difficulties to financial accounting and CPA auditing. This article selects the audit reports of A-share listed companies as a sample, and analyzes the main audit response measures for goodwill impairment matters listed in the key audit matters to understand the status of goodwill impairment audits by CPAs. Based on the statistical analysis results and the summary of relevant administrative regulatory measures of the China Securities Regulatory Commission, the main risk points of the current goodwill impairment audit inspection risks were summarized according to the audit business stages. Thirdly, this article selects representative audit cases of listed companies in the media industry for case analysis. After comprehensively elaborating on the goodwill formation and subsequent measurement process of the case company, this article conducts an in-depth analysis of the main audit measures taken by certified public accountants on the company's goodwill impairment matters, and analyzes the project's goodwill impairment based on the goodwill impairment audit risk model. Value audit risks are analyzed and problems that may lead to inspection risks are summarized. The conclusions drawn based on statistical analysis and literature review were verified, and the causes of the problems were analyzed based on the case background. Finally, this article puts forward countermeasures and suggestions for preventing and responding to goodwill impairment audit risks from both short-term and long-term aspects.

Keywords: Goodwill Impairment; Impairment Test; Audit Risk; Media Industry.

1. Introduction

Since 2014, corporate mergers and acquisitions in China's capital market have continued to rise and reached their peak in 2015. At that time, large-scale mergers and acquisitions not only brought about a surge in the stock market, but also gave rise to high valuations of merger and acquisition targets, high performance commitments, and a large number of high-premium mergers and acquisitions, which in turn continued to expand the scale of A-share goodwill. In March 2019, the CICPA and the Ministry of Finance respectively interviewed accounting firms and held warning meetings to remind them of risks related to annual report audits regarding goodwill impairment. The CPA's assessment and response to the goodwill impairment audit risk is directly related to the quality of the annual report audit. Recently, accounting firms have frequently received warning letters from the China Securities Regulatory Commission or local securities regulatory bureaus due to goodwill impairment audit issues.

This article selects representative audit cases of listed companies to study how to prevent and respond to the audit risk of goodwill impairment, which has strong practical significance. This article puts forward countermeasures and suggestions for the prevention and response of goodwill impairment audit risks, hoping to provide some reference for CPAs to carry out audits of goodwill impairment in the future, and hopes to provide guidance for the decision-making behavior of companies and other entities, the improvement of accounting standards and the capital market. Provide reference for healthy development.

2. Current Status and Audit Risks of Goodwill Impairment Audits of A-Share Listed Companies

2.1. Current Status of Goodwill and Goodwill Impairment of A-share Listed Companies

Among the 3,760 A-share listed companies that have disclosed their 2018 annual financial reports as of the end of 2019, 2,094 companies have goodwill items with non-zero amounts, accounting for 55%, and 899 companies have incurred goodwill impairment losses, accounting for approximately twenty four%. As shown in Table 3-1, all A-share listed companies confirmed a total of 166.7 billion yuan in goodwill impairment in 2018, accounting for 0.41% of the total net assets of the entire A-share market at the end of the year and 4.35% of the total net profit, far exceeding the previous five years. Among them, 159 companies accounted for more than 10% of the absolute value of net assets in goodwill impairment in 2018, 94 companies accounted for more than 30%, and 59 companies accounted for more than 50%. The reasons behind the large amount of goodwill impairment provision made by listed companies in 2018 are worthy of study and discussion. The impact of large goodwill impairment on the audit of annual financial reports also deserves the attention of certified public accountants. After a large amount of goodwill impairment provision was made in 2018, the goodwill scale of A-shares was still 1.31 trillion, accounting for 3.21% of the total net assets. Among them, the companies whose goodwill accounted for more than 30% of

the absolute value of net assets are 308 companies, and 121 companies account for more than 50%. The risk of goodwill impairment hidden by huge amounts of goodwill is still huge.

2.2. Current Status of Goodwill Impairment Audit by Certified Public Accountants

The new audit reporting standards promulgated at the end of 2016 require the key audit matters, the reasons for their selection, and the main audit response measures to be listed in the audit report. When selecting key audit matters, we focus on factors such as special risk matters and significant audit judgments related to significant management judgment matters. Therefore, this article understands the implementation status of goodwill impairment auditing by certified public accountants by sampling and counting the main audit responses to goodwill impairment matters listed in the key audit matters.

This article selects audit reports of A-share listed companies whose absolute value of the ratio of goodwill to net assets is greater than or equal to 0.6 as a sample, a total of 63 copies (including 21 from the media industry). Excluding 6 audit reports with disclaimer of opinion and 1 report that did not list goodwill impairment as a key audit matter, there were a total of 56 audit report samples that actually included the key audit matter of goodwill impairment. It is worth noting that the audit reports of companies with a high proportion of goodwill to net assets almost all list goodwill impairment as a key audit matter. Combined with the selection criteria for listing as a key audit matter, it can largely explain the performance of the company. Companies with a high proportion of goodwill to net assets have a high risk of material misstatement of goodwill impairment.

2.3. Current CPA Goodwill Impairment Audit Risk

The risk of material misstatement of goodwill impairment is related to the risk of the audited entity and exists independently of the audit work. During the recognition and initial measurement of goodwill, measurement inaccuracies such as overestimation of goodwill due to fraud or accounting errors will indirectly lead to management identification issues related to goodwill impairment in the subsequent measurement of goodwill. Problems in the subsequent measurement of goodwill directly lead to management identification issues related to goodwill impairment. The issue of goodwill impairment information disclosure, like the above-mentioned issues, is a link that creates the risk of material misstatement. It will cause relevant risks of material misstatement and requires CPAs to consider it when designing and implementing risk response measures.

The risk of goodwill impairment inspection depends on the effectiveness of the design and execution of relevant audit procedures. When the risk of material misstatement is high, CPAs need to design and perform more rigorous audit procedures and obtain more and higher-quality audit evidence to reduce the risk of goodwill impairment inspections as much as possible. The premise is to fully understand the main risk points of the current goodwill impairment inspection risk.

3. Case Analysis of Goodwill Impairment Audit of Zeus Entertainment

3.1. Relevant Information on the Impairment of Goodwill of Tianshen Entertainment

Tianshen Entertainment was established in 2003, and its legal representative is founder Zhu Ye. After mergers and acquisitions, the company's main business has expanded from the initial online game development and distribution to mobile application distribution, advertising marketing, and film and television entertainment businesses. In 2014, Tianshen Entertainment backdoored Dalian Kemian Wood Industry Co., Ltd. and listed it on the Shenzhen Stock Exchange through asset replacement, cash acquisition, etc. In 2015, it completed the company name change and completed the acquisition of 5 companies within the backdoor listing plan in the same year. After the backdoor listing in 2016 and 2017, Tianshen Entertainment directly acquired five companies at high premiums, accumulating huge amounts of goodwill. Regardless of whether the motive of Tianshen Entertainment's continuous mergers and acquisitions is entirely value creation or whether it is for stock market speculation and arbitrage, the consequences of the continuous mergers and acquisitions are that the scale has expanded dramatically and the company's value has been enhanced. However, in reality, the company has accumulated a large number of hidden risks. Direct manifestations of hidden risks include performance losses of subsidiaries, financial risks arising from the company's cash shortage and worsening solvency indicators. In 2018, the company accrued the highest goodwill impairment of 4.06 billion for A-shares that year and became the "loss king" of A-shares, which can be regarded as the realization of risks.

On September 19, 2018, the company's actual controller Zhu Ye resigned from his positions as legal representative, chairman and general manager due to being investigated by the China Securities Regulatory Commission on May 9 of the same year. His successor Yang Kai has also resigned, and then the deputy general manager, financial director and other company executives have resigned one after another. The company's governance and management have undergone great changes. The Dalian Securities Regulatory Bureau also issued warning letters to Tianshen Entertainment, Zhu Ye, the annual report audit agency, the 2017 merger target value assessment agency, and the 2017 goodwill impairment recoverable amount assessment agency on the same day that the China Securities Regulatory Commission filed the case. The warning letter to the company and Zhu Ye involves issues such as information disclosure, capital occupation by the largest shareholder, corporate governance and internal control. The above-mentioned problems largely reflect the chaotic governance and weak control environment of Tianshen Entertainment. The warning letter to the third-party service provider directly involves the issue of goodwill valuation or goodwill impairment valuation and audit business.

3.2. Formation and Initial Measurement of Tianshen Entertainment's Goodwill

3.2.1. The Formation Process of Goodwill

Tianshen Entertainment completed a total of 9 acquisitions of 10 companies from 2015 to 2017 after the backdoor listing

(Avazu Inc. and Shanghai Maicheng were treated as a package deal during the acquisition). The nine acquisitions paid a merger consideration of 9.803 billion yuan in cash or cash plus the issuance of shares, and a total of 8.457 billion yuan of goodwill was recognized. The nine acquisitions were all high-premium acquisitions. The lowest merger premium rate was 200% and the highest was 1321.21%. The comprehensive merger premium rate was as high as 628.31%. Zeus Entertainment did not clearly explain the reasons for the formation of large amounts of goodwill in the notes to the statements.

3.2.2. Combined Cost Measurement

Taking the merger and acquisition of Fantasy Yueyou as an example, the transaction report shows that the asset appraisal agency used December 31, 2015 as the evaluation base date to evaluate the total equity value of Fantasy Yueyou shareholders based on the income method at 3.652 billion yuan, which is nearly 3.652 billion yuan higher than the book value of the net assets. 5 times. Based on the company's final negotiated merger cost of 93.54% of the acquired equity share, the merger plan was 3.417 billion yuan. The merger cost of Tianshen Entertainment's merger with Fantasy Joy Travel was almost determined based on the appraiser's valuation. Among the merger costs, 1.711 billion yuan was paid in cash and 1.705 billion yuan was issued in shares. The number of shares issued was 24,143,547 shares based on 90% of the average stock price on the 20 base days before the evaluation base date.

3.2.3. Measurement of Fair Value of Identifiable Net Assets

According to the disclosure in the notes to the financial statements of the year of Tianshen Entertainment's merger and acquisition, the method for determining the fair value of the acquiree's identifiable assets and liabilities is to calculate the identifiable fair value starting from the assessed value of the acquisition object on December 31, 2015, to the date of purchase. It can be seen from Table 3-2 that the difference between the fair value of the identifiable net assets and the book value of the 10 acquired parties in the 9 acquisitions is not large. The total identifiable fair value of the 10 acquired parties was calculated according to the assessed value on the assessment base date to the purchase date, totaling 612 million yuan, and the total book value was 571 million yuan. The difference between fair value and book value was only 7.28%. This is partly related to the asset structure of asset-light companies. The 10 acquired parties are all asset-light gaming and entertainment companies. A large proportion of their assets and liabilities are current assets and liabilities such as monetary funds and accounts receivable and payable. Due to their nature, the book value of these current assets is close to fair value. Therefore, the difference between the fair value of the identifiable net assets and the book value of the above-mentioned 10 acquired parties almost all comes from intangible assets.

3.3. Subsequent Measurement and Disclosure of Tianshen Entertainment's Goodwill

3.3.1. Subsequent Measurement of Tianshen Entertainment's Goodwill

Tianshen Entertainment Made a Total of 4.09 billion yuan in goodwill impairment provisions from 2015 to 2018 (excluding those transferred out due to the disposal of subsidiaries). The goodwill impairment provisionst have been

made account for 60.97% of the original value of goodwill. On an annual basis, the company's total goodwill impairment provisions in the three years from 2015 to 2017 were only 44 million yuan, but in 2018 it was as high as 4.06 billion yuan. In 2018, goodwill impairment losses accounted for 59.26% of total profits for the period, and accounted for 68.32% of the average total net assets at the beginning and end of the year. Judging from the acquisition targets that formed goodwill, goodwill impairment provisions were made in a large proportion or even in full for the goodwill recognized during the mergers and acquisitions of Miaoquhengsheng, Yihua Technology and Leishang Technology.

3.3.2. Tianshen Entertainment's Disclosure of Goodwill

The company is basically able to disclose information related to the initial recognition and measurement of goodwill in accordance with the requirements of the standards. However, for the mergers and acquisitions carried out in 2017, the notes to the statements for that year did not disclose the method of determining the fair value of the merger cost and the fair value of the acquiree's identifiable assets and liabilities, as well as the assumption of the acquiree's contingent liabilities.

Tianshen Entertainment made provision for goodwill impairment in 2016 and 2017. The company disclosed that the goodwill impairment test relied on the evaluation reports of two asset appraisal companies on the recoverable amount of the relevant asset groups of each subsidiary. The goodwill impairment of Tianshen Entertainment in 2018 was a major asset impairment, but the key assumptions and basis used to allocate goodwill to asset groups and the recoverable amount were not fully disclosed in the notes to the statements for that year as required by the standards. The present value of future cash flows uses information such as the discount rate and prior period discount rate. As of February 2020, when this article was written, the China Securities Regulatory Commission's investigation into the company's illegal information disclosure cases was still ongoing.

3.4. CPA Audit Implementation Status and Audit Risk Analysis

3.4.1. Risk of Material Misstatement of Goodwill Impairment

Due to the large proportion of goodwill in the balance sheet of Tianshen Entertainment and the large proportion of goodwill impairment losses in the income statement in 2018, and due to the complexity of goodwill measurement and impairment testing in nature, and the subjectivity involved, the audit team should focus on assessing whether there is a risk of material misstatement in the impairment of goodwill when auditing the annual report of Tianshen Entertainment.

3.4.2. Risk of Material Misstatement at the Financial Statement Level

Goodwill comes from corporate mergers and acquisitions, and the recognition and initial measurement of goodwill involves multiple determinations of multiple items in the financial statements; goodwill impairment losses are directly included in the income statement to offset profits, thereby affecting many financial indicators. According to the above analysis, during the initial measurement of goodwill and the process of impairment of goodwill, the management is likely to artificially adjust the income and costs of subsidiaries involved in goodwill across periods to perform earnings management. The control environment of Tianshen

Entertainment is weak. A large number of company executives resigned voluntarily in a short period of time. Control rights are too concentrated. Corporate governance problems are prominent. Management overrides internal controls. In addition, the media industry in which Tianshen Entertainment is located is an emerging industry with industry competition and unstable market development. In addition, the regulatory environment has become stricter in 2018, and the operating risks affected by external environmental factors are relatively high. Therefore, the audit team should consider assessing the risk of material misstatement at the financial statement level of Tianshen Entertainment as high risk and then effectively design and strictly implement targeted overall response measures.

3.4.3. Risk of Material Misstatement at the Identification Level

The impairment test of goodwill involves complex calculations but lacks observable data, and because it involves significant assumptions and is highly dependent on judgments, it is an accounting estimate that is affected by significant measurement uncertainty, coupled with the often existing management bias. The inherent risk of reputation impairment is relatively high. Tianshen Entertainment built its internal controls relatively late, and the management overrides the controls. Use internal controls related to expert work to judge and identify signs of impairment, identify asset groups and monitor their changes, determine the rationality of key parameters, segregate duties and appropriate authorization approvals, etc. to design and implement internal control procedures for goodwill impairment. The operational effectiveness is low and the risk of goodwill impairment control is high.

3.4.4. Special Risks

Since goodwill and goodwill impairment losses are extremely important to Tianshen Entertainment's financial reports, there are significant accounting estimates in determining the recoverable amount during the goodwill impairment process, so its risk of material misstatement is often a special risk of fraud risk. Therefore, CPAs need to specifically consider whether there are special risks in the Tianshen Entertainment goodwill impairment matter and then design and implement corresponding countermeasures. The fraud triangle theory can help the audit project team better identify and evaluate special risks caused by fraud, or verify the risk assessment results. As shown in summary, it can be seen that the risk of material misstatement in Tianshen Entertainment's goodwill impairment project is high or there are special risks. According to the goodwill impairment audit risk model, CPAs need to design and implement more rigorous audit procedures and obtain more and higher-quality audit evidence to reduce the risk of goodwill impairment inspections as much as possible.

3.5. Inspection Risk of Goodwill Impairment

Due to the professionalism and complexity of impairment testing, the subjectivity and difficulty in verifying the selection of important assumptions and parameters, and the uncertainty of goodwill impairment factors, it is often difficult for certified public accountants to obtain audit evidence and must rely on the work of valuation experts. And Tianshen Entertainment's special risks of fraud will affect the effectiveness of the design and execution of audit procedures. Therefore, members of the audit team need to maintain sufficient professionalism and professional skepticism

regarding goodwill impairment projects and strictly implement the requirements of auditing standards. And accounting firms are required to continuously improve internal operating guidelines for goodwill impairment, conduct quality control reviews in strict accordance with quality control review requirements, and reduce the risk of goodwill impairment inspections.

The auditors of Tianshen Entertainment's 2017 and 2018 financial reports were both Zhongshen Zhonghuan, but 4 audit agencies were changed within 5 years. Frequent changes of CPAs in themselves indicate that the company's financial condition is deteriorating, leading to harsher reservations and greater risks in the audit project (Nancy R. Mangold, 1989). Zhongshen Zhonghuan issued a more stringent qualified opinion on Tianshen Entertainment's 2018 annual financial report than the 2017 standard unqualified opinion, but the basis for forming the qualified opinion did not involve matters related to goodwill or goodwill impairment. In the audit reports of the 2017 and 2018 annual reports issued by Zhongshen Zhonghuan, the goodwill impairment test matter was listed as a key audit matter.

4. Countermeasures and Suggestions for Preventing and Responding to Goodwill Impairment Audit Risks

4.1. Improve Goodwill Accounting Standards

The reason why goodwill impairment matters often have a high risk of material misstatement is the complexity and subjectivity of goodwill measurement and goodwill impairment testing. In addition, goodwill information disclosure is not transparent, and the inherent risk of goodwill impairment is high. Therefore, the current goodwill-related accounting standards need to be improved. Improving the goodwill-related accounting standards can fundamentally prevent the risk of material misstatement of goodwill impairment and reduce audit risks.

4.2. Improve Corporate Governance and Internal Control

Higher corporate governance efficiency can weaken management's ability to manage earnings through goodwill and goodwill impairment, thereby preventing goodwill impairment audit risks caused by management bias or fraud. Specifically, by optimizing the company's control structure, preventing the emergence of extreme controllers, and effectively giving full play to the functions of the internal checks and balances of the board of supervisors and independent directors, we ensure the effective implementation of the collective decision-making system for major strategic decisions such as external investments and mergers and acquisitions. Improve internal control over goodwill impairment testing. The focus of improving the internal control of goodwill impairment testing includes but is not limited to the use of internal controls related to expert work, the judgment and identification of impairment signs, the identification of asset groups and monitoring of changes, the selection of valuation methods for recoverable amounts and the determination of key parameters.

4.3. Develop and Contact the Asset Appraisal Industry

Both goodwill accounting and CPA auditing suffer from the

problem of over-reliance on asset appraisers. Therefore, the development of the asset appraisal industry and its connections with listed companies and audit institutions can prevent the audit risk of goodwill impairment by CPAs in the long run. There are many things that need to be standardized and improved in the practice of appraisers, including but not limited to the purpose of appraisal, selection of appraisal methods, identification of identifiable assets, determination of asset groups, attention to signs of impairment, on-site investigation and data verification, and important parameters. Therefore, the asset appraisal industry needs to strengthen the construction of professional capabilities and strengthen the training and responsibility awareness of appraisal practitioners. Regulatory authorities should also focus on the assessment of goodwill-related assets and urge intermediaries to improve their professional quality through risk reminders, inquiry letters, special inspections, etc. In addition, my country's capital market needs to be further developed and improved, deepen the research on fair value measurement theory, build and improve the fair measurement system and market foundation, increase market activity, and provide data support for appraisers' goodwill-related value assessments.

4.4. Improve the Legal System and Regulatory Mechanism

A sound regulatory mechanism and a sound legal system can limit the company's earnings management motives and fraud motives, reduce the risk of goodwill impairment, and reduce the risk of goodwill audit caused by fraud. Our country currently needs to improve the relevant laws and regulations on mergers and acquisitions of listed companies, and strengthen the enforcement and punishment of violations of laws and regulations. First, more detailed and specific normative documents should be issued to deal with the complexity and unverifiability of goodwill measurement in mergers and acquisitions. Second, during periods of sharp stock market rises, high-premium mergers and acquisitions should be strictly reviewed, rigid constraints on stock price valuations should be introduced, blind cross-industry

restructurings should be strictly prohibited, and the risk of goodwill impairment should be reduced from the source. Third, we should strengthen the full-chain supervision of the goodwill accounting treatment of listed companies and severely crack down on the manipulation of goodwill assets by listed companies.

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