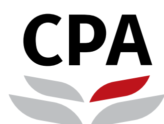
# Quality Assurance

## Annual Report

2012



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

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## Foreword

Fellow members

I am pleased to present our report on the achievements of the quality assurance department for 2012 under its practice review and professional standards monitoring programmes and the common findings identified in those reviews.

In 2012, we completed the second 3-year cycle of reviews of practices that audit listed entities. We once again achieved our target of visiting those practices at least once every three years. Their quality control systems and audits were generally of high or acceptable standards although there were still some cases that required follow up actions.

As has been the case in previous years, in 2012 follow up actions were needed for the majority of reviews of practices that do not audit listed entities. You will see from our report that many of the issues identified are the same as those found in the past. The good news is that the percentage of reviews requiring follow up action has dropped although only by a small amount. Most practices continue to be cooperative and receptive to our recommendations with remedial action generally taken in an effective and timely manner. Of course it would have been preferred if practices had actually paid more attention to, and avoided, common issues highlighted in our previous reports.

We remain committed to the educational value of practice review but our regulatory responsibilities cannot be ignored. The department and the practice review committee have a particular concern over the handful of firms that, despite having more than two visits by us, still continue to have significant deficiencies in their quality control systems and audit work. Our regulatory role demands that regulatory action(s) be taken against recalcitrant practices that consistently fail to meet the requirements of professional standards. Practices that continue to fail to comply with or observe professional standards will damage the image and reputation of the whole audit profession in the eyes of the public and therefore must be brought to task.

In 2012, we held meetings with the Ministry of Finance ("MOF") in Mainland China to work out arrangements to facilitate the review of Hong Kong auditors' working papers located in Mainland China. We shall continue our dialogue with the MOF in this regard to ensure the proper discharge of our regulatory function.

For professional standards monitoring, although we continued to identify certain deficiencies during our reviews of listed companies' financial statements, 2012 was a relatively quiet year as there were only a few new standards that became effective and their impact on most of the financial statements reviewed was minimum. However, from 2013 onwards, a number of new standards on investments that require restatement of balances from the beginning of the comparative period will become effective. Since these new standards contain new guidelines on how an investment should be classified, this may result in a significant change in the treatment of investments with consequences that will affect financial statements. Entities should start considering the impact of these new standards in their 2012 financial statements.

It is generally known that the Hong Kong system of auditor regulation is currently under review. There has been speculation that inspection of practices auditing listed entities may be removed from the Institute's practice review programme to strengthen the independence of the regulatory regime. No final decisions have yet been made and the Institute will continue to participate in the review process. Appropriate public and members' consultation will be conducted in 2013. Whatever the outcome, the Institute will remain committed to ensuring its members maintain the highest professional standards in auditing and financial reporting.

Finally, I would like to thank the members and practices that have been subject to our reviews under our quality assurance programmes. It is with their commitment and co-operation that we are able to demonstrate the full value of our quality assurance programmes. I firmly believe that, whatever changes for the audit profession may result from future regulatory reform, the Institute will continue to play a vital role in maintaining the quality of the profession and its contribution to Hong Kong's success.

Elsa Ho
Director, Quality Assurance, Hong Kong Institute of CPAs
March 2013

## Oversight of our work

The Quality Assurance Department ("QAD") has two primary areas of responsibility, practice review and professional standards monitoring.

The responsibility for oversight of QAD activities rests with the Standards and Quality Accountability Board ("the SQAB"). The SQAB ensures that QAD activities are carried out in accordance with strategies and policies determined by Council and in the public interest. The SQAB receives and reviews yearly plans and budgets and regular progress reports from management and reports to Council on its observations and views in relation to performance and operations. Please refer to Annex for members of the SQAB.

## Our work and review outcomes – Practice review programme

Practice review is a quality assurance programme that monitors all practising certificate holders in Hong Kong engaging in provision of audit and other related assurance services ("Practices"). The Professional Accountants Ordinance ("PAO") has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards.

The Practice Review Committee ("the PRC" or "Committee") is a statutory committee responsible for exercising the powers and duties given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. The QAD reports to the Committee and the Committee makes decisions on the results of practice reviews. According to section 32A of the PAO, at least two thirds of the Committee members must hold practising certificates. The practising members of the Committee are drawn from the full spectrum of audit firms, representing small Practices through to the Big Four firms. The composition of the Committee is reviewed by the Nomination Committee of the Institute every year to ensure a balanced composition. Please refer to Annex for members of the Committee.

*Our work*

The practice review process can be divided into three stages:

**Stage 1 – Preparation**
- Select Practice for visit
- Agree on visit date and request key documents
- Preliminary assessment of submitted key documents

**Stage 2 – On-site Visit**
- Opening meeting
- Conduct interviews
- Review compliance with HKSQC1 and review selected audit files
- Summarize findings and recommendations
- Exit meeting

**Stage 3 – Reporting**
- Draft report to Practice for formal response
- Review Practice's response
- Submit Reviewer's report to the PRC for consideration
- Advise Practice of the PRC decision
- Monitor follow up action, if needed

Selection of Practices for review is based on their risk profiles, primarily from information obtained from the electronic self-assessment questionnaire ("the EQS") and other relevant sources:

| Practices | Frequency of review | Note |
|---|---|---|
| Big Four | Annually | 1 |
| Practices with a significant number of listed clients | Subject to a full review at least every three years and an interim review during the three-year cycle | 2 |
| Other Practices with listed clients | Subject to review at least every three years | 3 |
| Other Practices | Based on risk profiles and random selection | 4 |

Note:

1. This recognizes the predominance of listed and other public interest entities in Big 4 client portfolios.

2. Practices with more than 20 listed clients will receive an interim review in addition to a full review every three years.

3. This is in line with international best practice.

4. Practices with other public interest clients, for example, banks, insurance companies, securities brokers, insurance brokers are given priority for reviews. A number of Practices are selected for reviews on a random basis to ensure that all Practices will have a chance of being selected.

The scope of each review includes obtaining an understanding of the Practice's system of quality control, assessing compliance of policies and procedures with HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* and reviewing conduct of audit work. The detail and extent of review work that the QAD carries out varies from Practice to Practice depending on the size of the Practice and the nature of the client base.

An area of continuing focus in 2012 was how Practices applied professional skepticism in the audit process. Practice reviewers considered whether Practices had applied sufficient professional skepticism from acceptance to completion of an engagement. Special attention was placed on assessing whether Practices applied sufficient professional skepticism in assessing the reliability of evidence obtained in respect of areas which are likely to involve considerable management judgment, e.g., valuations, impairment of assets and going concern.

Matters identified during reviews are fully discussed with the Practices. The QAD is responsible for drawing conclusions and making recommendations to the PRC for consideration and decision. The PRC having regard to the report and any response by the Practice to the matters raised in the report may act under the power given by the PAO, to:

- conclude a practice review with no follow up action required ("direct closed");
- make recommendations and specific requests to a Practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings ("required follow up action");
- instruct that another visit is required ("required follow up visit"); or
- make a complaint to initiate disciplinary action.

Each Practice is sent a formal notification of the PRC decision. The QAD monitors the progress of action undertaken by Practices at the direction of the PRC.

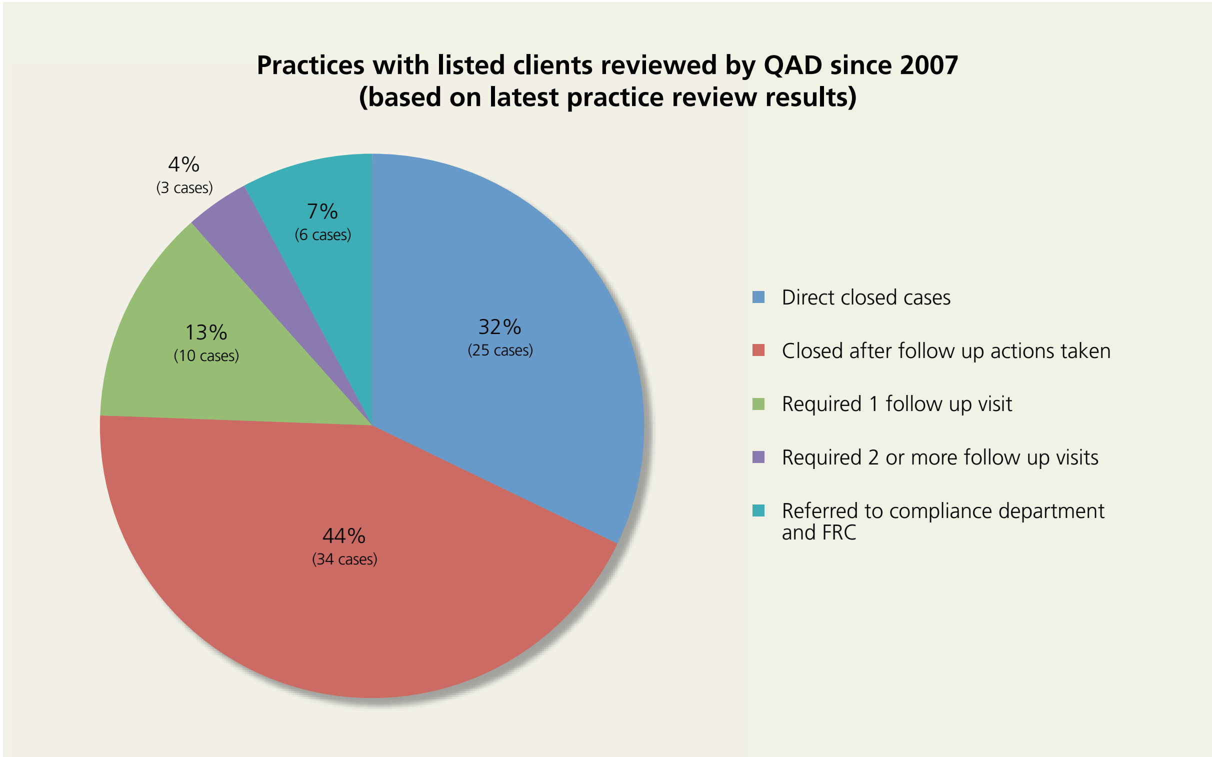
If an auditing, reporting or relevant irregularity is identified in respect of a listed company, the PRC may, via Council of the Institute, refer the case to the Financial Reporting Council ("the FRC").

*Our review outcomes*

The number of reviews carried out every year has increased steadily from 83 in 2008 to 214 in 2012.

In 2012, the QAD completed the second review cycle of all Practices with listed clients. In the second cycle, the QAD carried out 58 initial visits and 17 follow up visits on Practices with listed clients. More follow up reviews may be needed after concluding the reviews conducted in 2012. A total of 123 listed entity audit engagements were reviewed by the QAD during this cycle.

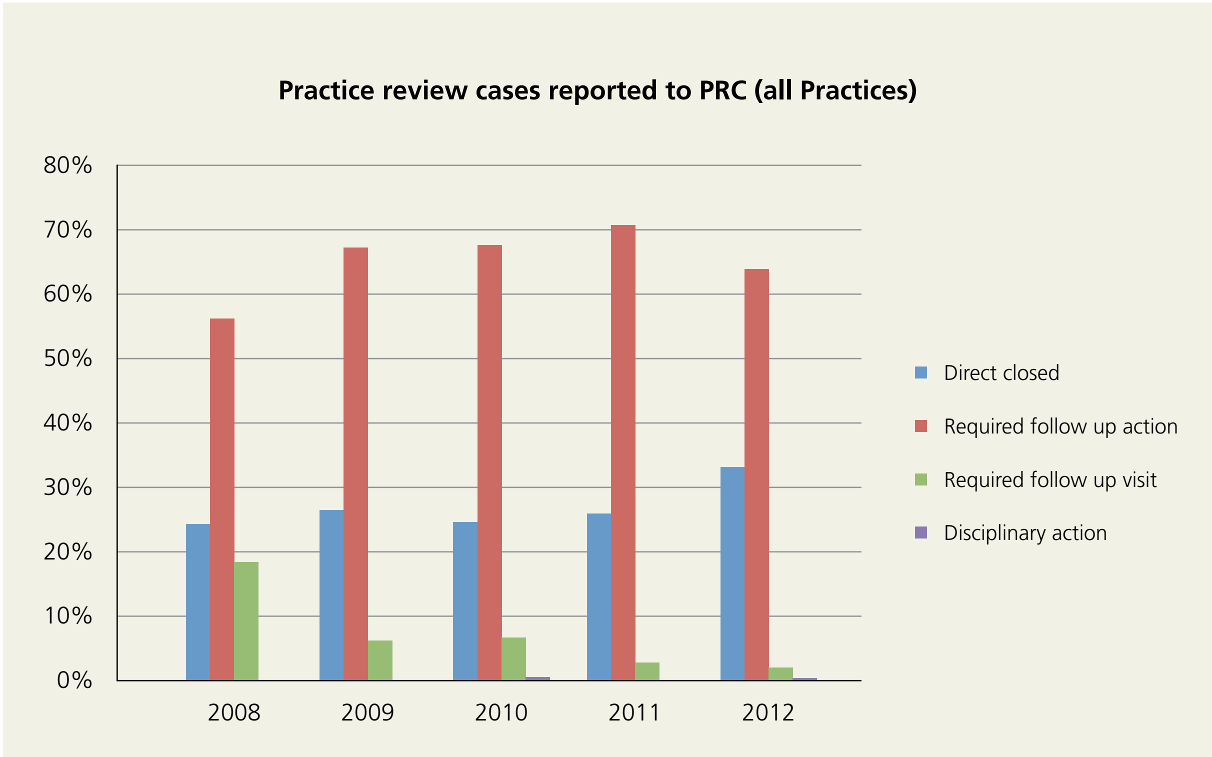
Since the launch of the revised practice review programme in 2007, a total of 83 Practices with listed clients have been visited by the QAD. For Practices where significant findings were identified, the PRC has directed the QAD to conduct follow up visits to ensure that findings had been properly addressed and that improvement was made on weaknesses identified. Five cases have been referred to the FRC for further investigation. One investigation resulted in a complaint raised against one Practice with listed clients as the Practice had serious non-compliance with professional standards and serious technical failings. That complaint was completed with disciplinary actions taken. The other cases are still under investigation by the FRC. The PRC has also raised a complaint against one Practice with listed clients on the grounds that the Practice did not comply with the Corporate Practices (Registration) Rules.



The PRC met on eleven occasions in 2012 and considered reports on 180 Practices. The PRC concluded that 62 cases should be closed without requiring any follow up action. For 113 cases, Practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Four cases required a follow up visit to assess the effectiveness of remedial actions taken. One case required a follow up visit and was also referred to the FRC.

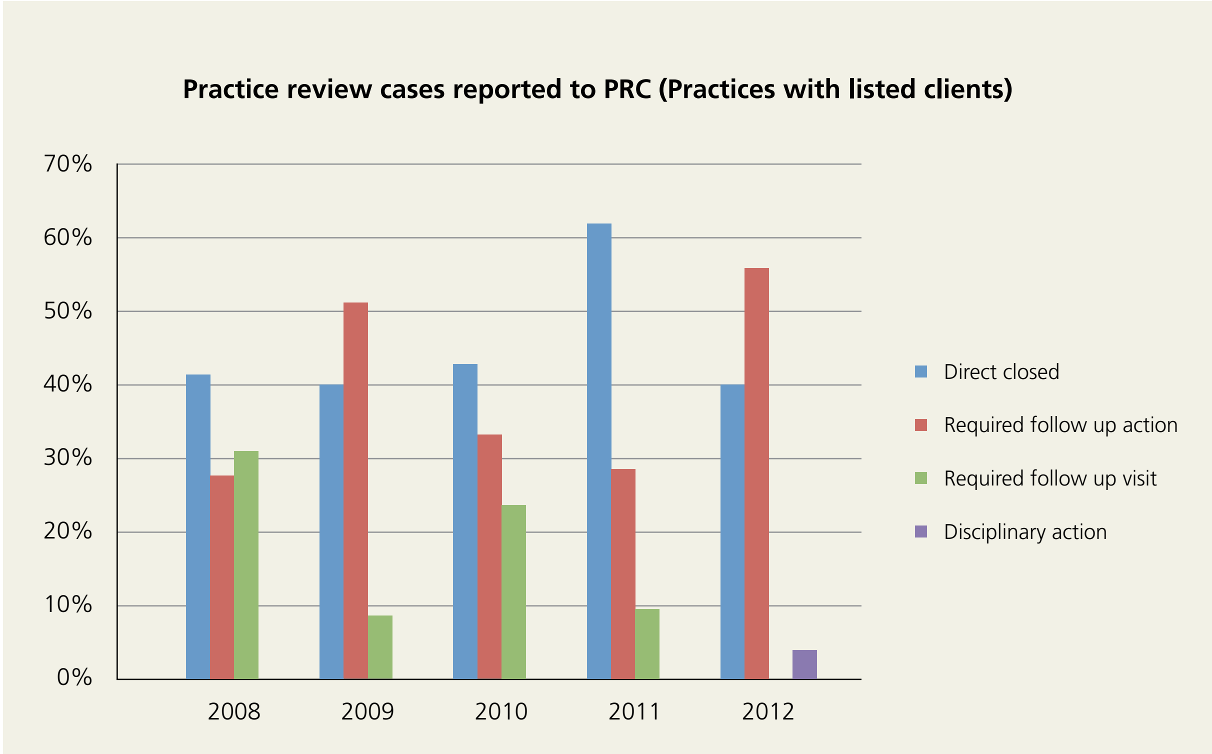
In addition to the 180 "first time" practice reviews, 12 follow up visits were reported to the PRC in 2012. Four cases were closed on the basis that adequate remedial actions had been taken, four cases required further follow up actions and four cases were either referred to the FRC or proceeded to a complaint.

The "first time" practice review cases reported to the PRC which have been directly closed increased from 26% in 2011 to 33% in 2012. The majority of reviews have continued to require remedial action, follow up visits or even disciplinary action.

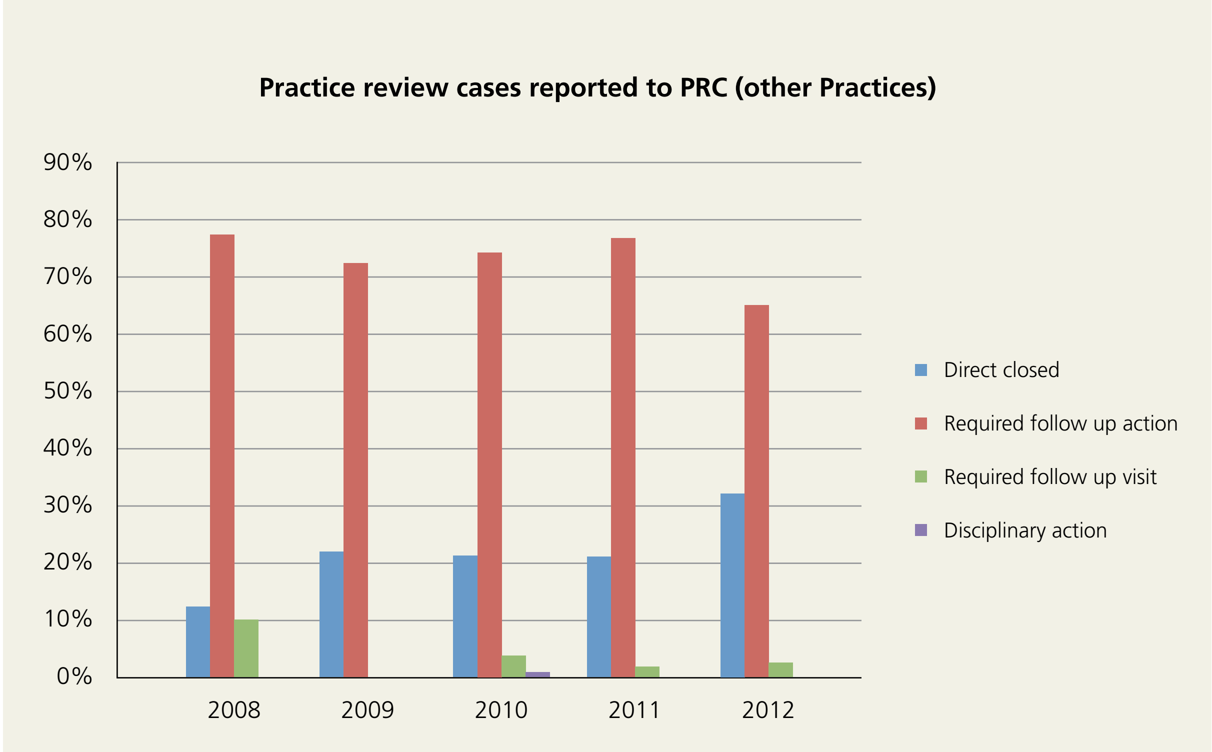


The outcomes of 2012 reviews are further analyzed into (1) Practices with listed clients and (2) Other Practices.

For Practices with listed clients, directly closed reviews have decreased from 62% in 2011 to 40% in 2012. In 2012, the QAD visited six Practices which took up listed client engagements for the first time of which four required follow up action and one required a follow up visit and was referred to the FRC. These six Practices only have one or a few listed clients. The results of reviews suggest that audits of listed entities demand a much higher level of resources and technical knowledge than some of the Practices had anticipated.



32% of the reviews of other Practices were directly closed in 2012, representing an increase of 11% from 2011. The cases that required follow up action have decreased from 77% in 2011 to 65% but this remains a high percentage. The results of reviews suggest that the level of compliance with professional standards, especially HKSQC 1 (Clarified), has not significantly improved.



One of the reasons that a case may not be closed directly is because of unsatisfactory responses provided by the Practice. For example:

- no appropriate or effective follow up action proposed to address significant findings;
- unable to demonstrate real understanding of or inability to resolve the issues;
- responses were very general or brief such that the QAD could not understand what follow up actions or procedures to address the findings were being proposed;
- no timeframe provided for follow up actions to be undertaken; or
- no commitment was shown to properly address the findings.

For some cases, findings identified during practice review were considered to be very significant. Therefore even if the Practice provided a relevant action plan, the PRC still considered it necessary to monitor progress to ensure that action taken was effective in addressing identified weaknesses.

Although the QAD has communicated common practice review findings to practitioners through different means in the past few years, the same issues continue to be identified. The most typical example is the lack of monitoring review procedures, although the relevant requirements have been in place since 2005. This type of case usually cannot be closed directly and the PRC will direct the Practice to complete a monitoring review within a reasonable timeframe and provide the monitoring report to the QAD for assessment.

## Our work and review outcomes – Professional standards monitoring programme

The programme is a comprehensive financial reporting review programme. The programme was established in 1998 with the objective to enhance the quality of financial reporting and application of professional standards in Hong Kong.

The QAD carries out regular reviews of published financial statements of listed companies in Hong Kong. Enquiries are raised with members (primarily auditors of listed companies) in relation to matters identified from the reviews. The programme is primarily educational. However in view of the public interest in listed companies, if there are significant potential departures from professional standards identified during the reviews that may constitute a "Relevant Irregularity" or a "Relevant Non-compliance" as defined under the Financial Reporting Council Ordinance, the financial statements may be referred to the FRC for investigation according to established procedures.

The programme is supported by external reviewers from Big Four and medium-sized practising firms and the Professional Standards Monitoring Expert Panel ("Expert Panel"). The Expert Panel comprises members from Big Four and medium-sized practising firms, one practising under his own name, a representative from Hong Kong Exchanges and Clearing Limited ("HKEx") and one non-practising member. Please refer to Annex for members of the Expert Panel.

*Our work*

The QAD issues enquiry letters to members in respect of matters identified during the course of reviews which indicate potential non-compliance with professional standards. There are also situations where the disclosures in relation to significant matters or transactions noted from reviews are not sufficient to enable the QAD to assess whether there are non-compliance with professional standards. As such, enquiries may be raised to ask members to provide information or clarify the accounting treatment. There are also occasions when enquiries might be raised on potentially significant audit matters although the programme mainly focuses on financial reporting.

When the QAD encounters significant, complex or controversial issues during the review process, members of the Expert Panel are consulted to obtain their views on the application of professional standards in relation to those issues and assist the QAD in arriving at appropriate follow up actions and conclusions of reviews. With the strong support of the Expert Panel, the QAD ensures that enquiries made and conclusions reached on cases reviewed under the programme are appropriate.

The professional standards monitoring process can be divided into three stages:

**Stage 1 – External review**

- Published financial statements assigned by the QAD to external reviewers for initial reviews

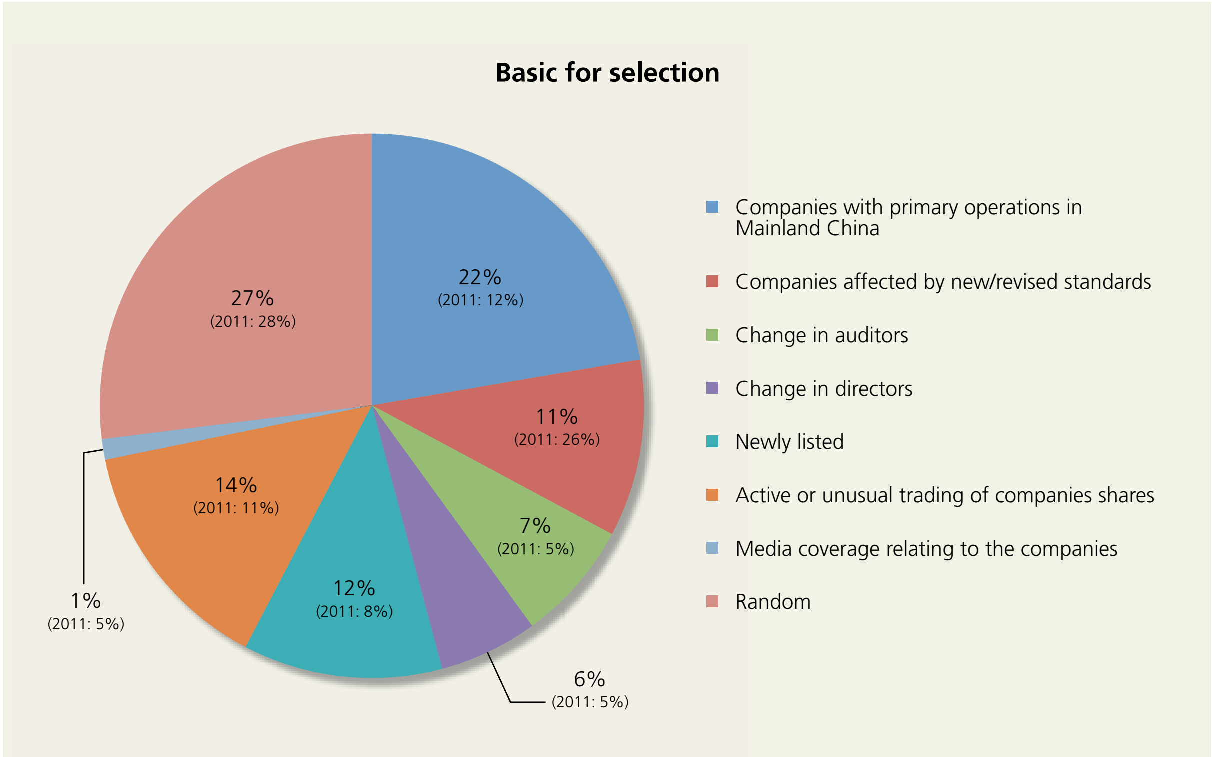
**Stage 2 – QAD review**

- The QAD reviews reports prepared by external reviewers and decides whether enquiry is necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

**Stage 3 – Follow up**

- The QAD reviews reply letters from members and decides whether further enquiry is necessary or other appropriate actions for the case
- The QAD consults the Expert Panel on significant, complex or controversial issues

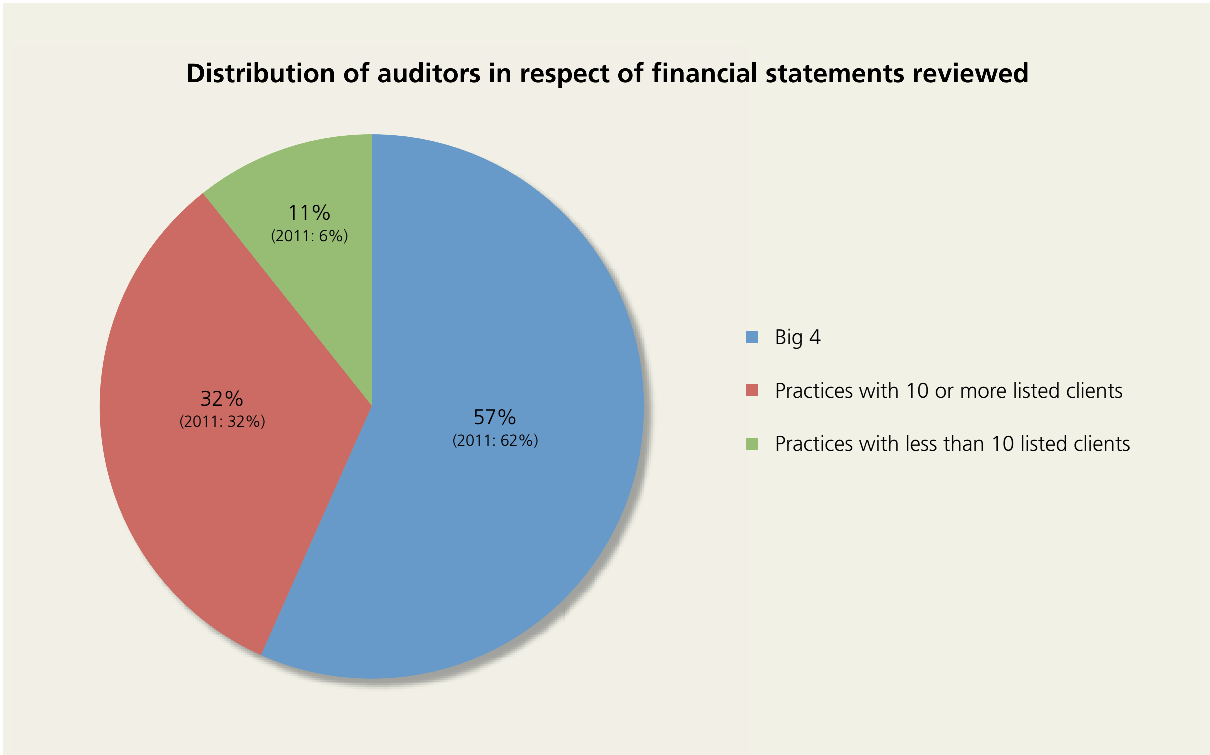
Selection of financial statements for review is risk-based. The following chart shows the basis of financial statements selected for review in 2012.




The basis of selection for 2012 was broadly the same as 2011. However the distribution of "Companies with primary operations in Mainland China" increased as compared to 2011. The main reason is that more A+H and H-share financial statements were reviewed during the year under arrangements with the FRC and HKEx to share the review of financial statements of Hong Kong listed companies that use Chinese Accounting Standards for Business Enterprises ("CASBE financial statements"). Please see "Our review outcomes" for more information about the reviews of CASBE financial statements.

Fewer financial statements were reviewed under the criterion "Companies affected by new/revised standards" as the application of new and revised financial reporting standards that were effective for annual periods commencing from 1 January 2011 did not have a significant impact on the majority of financial statements.

The QAD also considered the proportion of market share of respective auditors in selecting the number of financial statements reviews for auditors. This means auditors which have more listed clients will have a higher chance of being selected. The following chart shows the overall distribution of auditors in respect of financial statements reviewed in 2012:

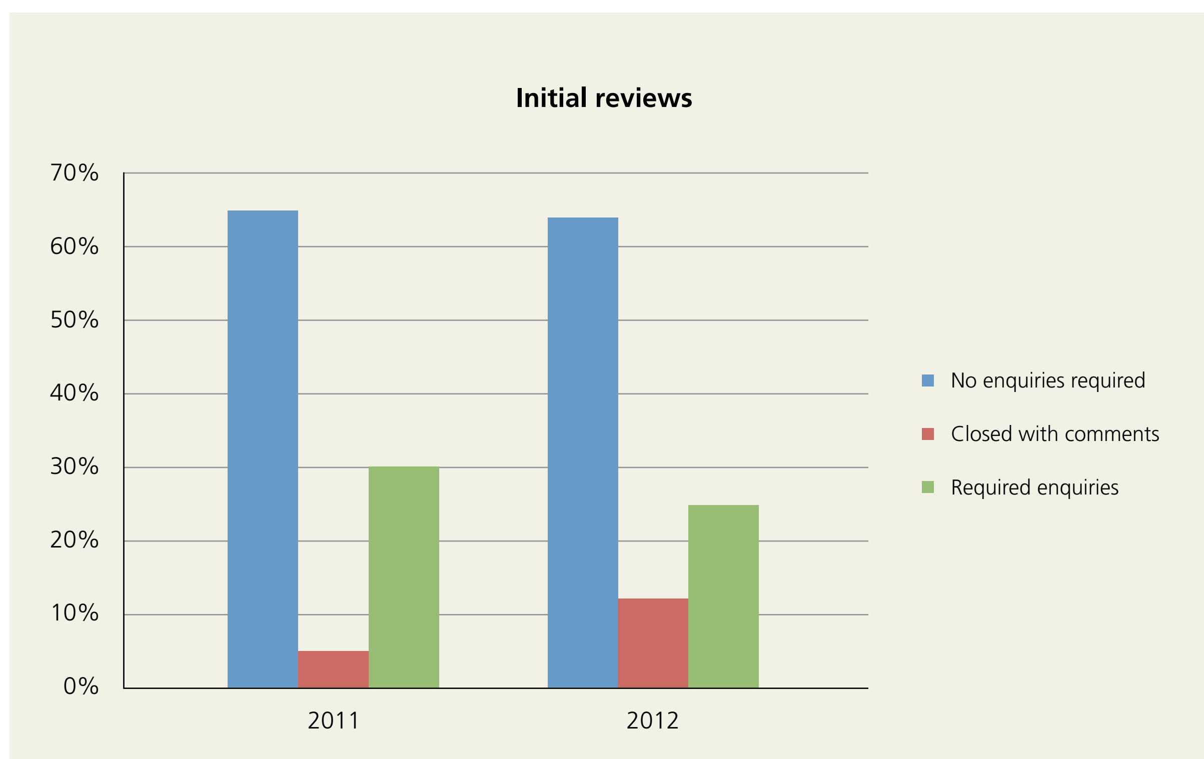


*Our review outcomes*

In 2012, the QAD reviewed 85 sets of published financial statements and followed up 8 cases brought forward from the previous year. During the year, the QAD issued 49 letters and handled 28 responses from auditors. Of 85 cases closed, 78 related to financial statements reviewed during the year and 7 were brought forward from the previous year including 2 which were referred to the FRC in the previous year and investigation was completed in 2012. Amongst 8 brought-forward cases followed up during the year, 5 were closed, 1 was referred to the FRC and 2 required further follow up actions.

In 2012, the QAD consulted with panel members on complex or controversial issues arising from reviews of financial statements of seven listed companies. More than one round of consultation was necessary for some cases.

As shown in the chart below, it is pleasing to note that as for 2011, no follow up action was needed for the majority of financial statements reviewed in 2012.




As explained earlier, referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. The Institute referred 2 cases to the FRC in prior years and 3 more cases in 2012.

By mid March 2013, the FRC had completed investigations on all 5 cases referred. Based on the FRC investigation results, 2 cases were closed in 2012 and the remaining 3 are being considered for further regulatory action.

*Cooperation with the FRC and HKEx*

The Institute, the FRC and HKEx carry out similar programmes of reviews of listed company financial statements. The Institute regularly communicates with the other two bodies to avoid duplications of reviews amongst the three bodies.

A joint financial reporting forum with the FRC and HKEx was held on 6 November 2012 which was fully subscribed and attracted approximately 280 attendees. The representatives of the three bodies shared common or significant observations identified from reviews of financial statements of listed companies.

As mentioned earlier, the QAD, the FRC and HKEx have shared the reviews of CASBE financial statements. There were 28 listed companies (2011: 4) which used CASBE for preparation of 2011 financial statements. Between the three organizations, all 28 sets of financial statements were reviewed of which the QAD has reviewed 9 (2011: 1). It is encouraging to note that there were no significant findings from the reviews of CASBE financial statements carried out by the three bodies.

## Our findings

*Practice review programme*

This is the sixth year we have issued an annual report under the revised practice review programme. Since the commencement of our revised review programme, we have visited all larger Practices more than once. We have also made good progress in visiting smaller Practices. Practices have generally been cooperative and receptive to our findings and recommendations.

This section sets out a summary of common findings identified during the course of our reviews, many of which have been raised in previous reports, which Practices should give continued focus and attention to:

### *1. Quality control procedures*

To meet the requirements of HKSQC 1 (Clarified), most Practices have developed quality control policies and procedures either by themselves or based on the Institute's "A Guide to Quality Control". However, the following findings were commonly noted:

- There were inconsistencies between policies and procedures in Practices' quality control manuals ("QCM") and those actually applied.
- Practices had not established file assembly policies and procedures to ensure that the assembly of final engagement files was completed within 60 days of the date of the audit report.
- Practices did not ensure that subcontractors follow the Practice's QCM, such as requirements on independence and confidentiality and application of the Practice's audit methodology.
- Client acceptance and continuance checklists were completed in a cursory manner without giving proper consideration.
- A monitoring function had not been established.
- Practices did not consider the frequency of a monitoring review.
- No follow up actions were proposed to address monitor's findings.
- The effectiveness of monitoring reviews was in question as monitors failed to identify significant deficiencies.

Instances were found where Practices introduced quality control policies and procedures for the first time just prior to the practice review, which appeared to be a reaction to notification of review.

### *2. Independence*

The QAD continued to come across many smaller Practices that did not properly go through the "threat and safeguards" process when offering non-assurance services to their audit clients. When there is an indication of a potential threat to independence, Practices should clearly document their thought process and results of the assessment i.e. evaluation of the significance of potential threats to independence, the need for any safeguards and the safeguards applied.

*3. Subcontracting arrangements*

As mentioned in previous reports and forums, we recognize that subcontracting arrangements allow access to flexible additional resources when needed for some Practices. Subcontracting arrangements are acceptable as long as Practices are able to exercise appropriate control over the subcontractors' work. Nevertheless, we continued to identify a number of issues on Practices' control over the quality of work performed by subcontractors, particularly when audit clients were introduced to Practices by subcontractors:

- Subcontractors had carried out most/all of the audit work before approaching Practices to request their involvement.
- Practices had no relationship with the clients as all contact with clients was by subcontractors.
- Practices were not aware of the fact that their subcontractors provided non-assurance services to their clients, as well as being involved in audit work, which posed independence and self-review threats.
- Practices did not have timely involvement in the work of subcontractors e.g. Practices have no involvement in audit engagements until subcontractors completed the audit work and passed the files to Practices for review.
- Subcontractors did not respond to review queries raised by Practices and did not allow Practices to contact clients to clear queries.
- Audit files were retained by subcontractors which were not readily accessible by Practices, or certain important audit evidences were kept by subcontractors and not on audit files.

Practices should carefully assess whether adequate and appropriate quality control can be duly exercised over subcontracted engagements before accepting new engagements or continuing existing ones. If Practices are unable to exercise proper control over subcontractors and their work, they should terminate the subcontracting arrangements or resign as auditors of referred engagements. Practitioners who fail to comply with the *Code of Ethics for Professional Accountants* ("Code") and professional standards when performing audits may be subject to disciplinary action and may risk losing their licence.

*4. Fraud risks consideration*

HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires auditors to consider fraud risk in an audit. However, the QAD considered that audit work in relation to fraud risks still required improvement to address the following:

- There was insufficient consideration of fraud risks arising from management override of controls and respective audit procedures e.g. journal entry testing.
- Practices did not consider additional fraud risk factors relevant to audits of regulated clients as set out in PN 820 *The Audit of Licensed Corporations and Associated Entities of Intermediaries*.
- There was no documentation of inquiry of management on fraud when gaining an understanding of clients.
- There was no documentation to evidence that audit teams discussed the susceptibility

of clients' financial statements to material misstatement due to fraud.

- There was no documentation to show how audit teams had rebutted the presumption of risk in revenue recognition.

Some Practices believed that scrutinizing the general ledger could fully address the risk of management override of controls. Practices are reminded that, HKSA 240 (Clarified) specifically requires Practices to select journal entries and other adjustments made at year-end (e.g. non-routine entries, entries/adjustments made by individuals who typically do not make journal entries, entries contain round numbers or consistent ending numbers) and consider the need to test journal entries and other adjustments throughout the year. This work procedure is necessary as material misstatement of financial statements due to fraud often involves manipulation of the financial reporting process by:

- Use of inappropriate or unauthorized journal entries which may occur throughout the year or at period end; or
- Use of adjustments to amounts reported in the financial statements that are not reflected in journal entries e.g. consolidating adjustments and reclassifications.

Practices should ensure that fraud risk of management override is fully included in audit planning and document clearly on audit files the details of procedures performed e.g. criteria used to identify significant and unusual journal entries and details of journal entries, discussions with audit team and management in relation to the possibility of fraud.

### *5. Audit materiality*

Typical issues identified in relation to the determination and application of audit materiality were as follows:

- Overall materiality and performance materiality were not established at planning or applied during the audit.
- Performance materiality was larger than overall materiality.
- The materiality computed was not used for determining the nature, timing and extent of audit procedures.
- There was no documentation of thought process to support a revised basis for final materiality which was different from the basis used in determining initial planning materiality.
- There was no documentation to support the final determination of materiality computed based on different benchmarks (e.g. profit before tax, gross revenue, gross profit, etc) with a range of percentages.

Practices should determine both overall and performance materiality levels in accordance with HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit*. The level of materiality is critical to the nature and extent of audit testing performed and the assessment of issues arising from that testing.

### *6. Audit evidence and related judgment*

The QAD continued to have concerns about the quality of audit evidence on audit files to support auditor's judgment on areas such as impairment

of goodwill and other intangible assets and going concern assessment. In general, we considered that the level of challenge by audit teams to key assumptions adopted by clients was not rigorous enough to support their conclusions on whether impairment was not required or adequately made.

- Impairment assessment

  An audit client has the responsibility for determining whether the value of an asset has been impaired and then estimating the recoverable amount of the asset, while the auditor has the responsibility for making a critical assessment, with a questioning mind, of the validity of evidence provided by the client. During our review, various common issues were identified:

  - over-relied on clients' explanations and representations;
  - obtained audit evidence that corroborated rather than challenged clients' judgment e.g. took a macro view and general economic outlook optimistically to support client's "best" estimates;
  - did not explore further evidence available on other parts of the audit files that appeared inconsistent or contradictory e.g. source data used by the client in discounted cash flow ("DCF") may be inconsistent with other parts of the audit file; and
  - did not assess reasonableness of assumptions underlying the client's decisions with reference to historical outcomes e.g. appropriateness of growth rates used by the client which appeared to be unrealistically high.

  In addition to concerns about the level of challenge to key assumptions, the QAD also identified the following weaknesses in DCF impairment assessment which audit teams apparently did not address in their work:

  - DCF included cash inflow and outflow from financing activities;
  - A pre-tax discount rate was adopted for a post-tax cash flow in DCF;
  - Failing to identify correct cash generating units for impairment testing; and
  - Failing to identify appropriate discount rates.

  In general, Practices should heighten the level of professional skepticism when assessing evidence in areas that involve significant estimation or judgment by clients. Persuasive audit evidence should be obtained on these areas. Practices should ensure the sufficiency of audit evidence on files to reduce the risk of being challenged by external reviewers or regulators in relation to audit procedures performed or conclusions reached on key audit areas and in audit reports. Training should be provided to improve staff understanding of the accounting requirements of HKAS 36 *Impairment of Assets*.

- Going concern assessments

  Issues over sufficiency of work undertaken in relation to the going concern assumption for the preparation of the financial statements were often identified:

  - Sufficiency of evidence of financial support from holding company or individual shareholder;

- Extent of work performed on cash flow forecasts supporting the going concern assessment; and
- Adequacy of disclosures relating to going concern uncertainties.

Some Practices completed standard checklists with "tick" marks without any thought given to the sufficiency and appropriateness of the audit evidence gathered. For example, a going concern checklist was completed which highlighted that the client had net current liabilities with operating cash outflow and incurred significant losses with no income for many years but there was no further evidence on files to indicate these going concern indicators were properly considered before the audit report was issued.

There was also a lack of evidence that audit teams challenged information provided by clients to support their assumption that the entity was a going concern. Some Practices accepted client's estimates of future cash flows without critically assessing the underlying assumptions.

Practices should evaluate a client's assessment of its ability to continue as a going concern under HKSA 570 (Clarified) *Going Concern*. The Standard also requires Practices to undertake specific procedures when events or conditions that may cast significant doubt on client's ability to continue as a going concern have been identified.

### *7. Reliance on professional valuation*

The QAD continued to have concerns about shortcomings in the use of the work of experts:

- There was insufficient challenge of the assumptions used by experts.
- Practices did not perform any assessment on the independence and competence of the expert.
- Practices did not assess the adequacy of the expert's work for audit purposes before placing reliance on it.

In some cases, Practices used their own experts to provide assurance in areas of their client's financial statements, where the client management has relied on its own expert. In one review, the Practice concluded that there was no impairment on a significant asset based on verbal discussions with its own expert, but the valuation report issued a few months after the audit report date revealed potential impairment of the asset which had a significant impact on the financial statements.

Practices should ensure that they give appropriate consideration to any issues identified by their own expert and have evidence that those issues have been appropriately resolved before signing the audit report. If a Practice concludes that the work of the expert is not adequate, the Practice should request the expert to carry out further work or the Practice itself should carry out additional audit procedures as appropriate.

*8. Group audit considerations*

HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* introduced more specific requirements for the conduct of group audits including a requirement for greater involvement by the group auditor in the audit of significant components. Common issues identified in relation to group audits were:

- Restrictions on involvement of group auditors in the work of component auditors, such as their risk assessment process;
- Inability to gain access to component audit files
- Group auditors did not assess component auditors' independence and competence before placing reliance on component auditors' work;
- There was no analysis of components in the group to determine those that are significant, and the type of work that should be performed on the financial information of the components;
- There was insufficient justification of the scoping and materiality established for component audit procedures;
- There was insufficient evidence to show that group auditors had considered the appropriateness of work performed by component auditors e.g. whether significant issues noted by component auditors had been fully addressed, or whether the work done by component auditors was in accordance with group instruction issued; and
- Group auditors failed to follow up on potential audit issues identified by component auditors in their reporting deliverables.

Where a Practice is a member of an international network of firms, it often uses a member firm of the same network for audits of client's overseas subsidiaries. Sometimes, a Practice informed us that it had frequent communications with the component auditor and reviewed their working papers but evidence of this was not sufficiently documented on group audit files. Practices are reminded that it is still necessary for the group auditor to appropriately consider the independence and competence of the component auditor and evaluate the work done by them even when the component auditor is a member firm of the group auditor's network in other jurisdiction.

HKSA 600 (Clarified) makes it clear that the group audit partner is responsible for the direction, supervision and performance of the group audit and ensuring that sufficient appropriate audit evidence is obtained. The group auditor needs to be adequately involved in the work of the component auditor throughout the audit. The group auditor should therefore consider the extent to which it needs to be involved in component audits and whether appropriate arrangements can be made with component auditors at an early stage, e.g. during the acceptance and continuance process. If the group auditor is unable to ensure appropriate cooperation by the component auditor, the group auditor should plan to carry our audit work themselves on components. If sufficient appropriate audit evidence cannot be obtained on the components, the group auditor should modify the group audit opinion.

*9. Modified auditor's opinion*

The following weaknesses were identified when Practices modified opinions in auditor's reports:

- Practices did not complete all necessary audit work before concluding a disclaimer of opinion was appropriate.

  As previously reported some Practices misused disclaimers of opinion to circumvent necessary audit procedures. Some Practices informed us that the disclaimer opinion was given due to time constraints as a result of tax deadline and audit teams were unable to complete all necessary audit work to issue a clean opinion. We consider that lack of time is not an acceptable reason to disclaim an opinion. Practices should assess resource requirements and availability before confirming any engagement acceptance or continuance decision.

- Practices issued modified opinions in respect of non-attendance at client's stock-take.

  A number of smaller Practices often issue qualified opinions on inventories when inventory counts were not attended. We were concerned that the Practices had simply issued qualifications without taking steps to resolve the circumstances that gave rise to the limitation of scope. Practices should understand reasons for not being invited to attend inventory counts. If the reasons were that the inventories were located outside Hong Kong or the clients were at peak season at the year-end date, they should consider, for example, (1) engaging another auditor or a suitably qualified person as their representative to attend the inventory count and to report on the results to them; and (2) arranging inventory counts with clients on dates other than the year-end date.

  Practices are reminded that stock-take attendance is an important and necessary audit procedure which serves not only the purpose of confirming the existence of stock, but also evaluation of physical controls over stock and identification of damaged, slow moving or obsolete stock.

- Inconsistent wordings were inadvertently used in auditor's reports as Practices did not realize that qualified opinion and disclaimer of opinion are different types of modification to the auditor's opinion.

  HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report* establishes three types of modified opinions: a qualified opinion, an adverse opinion and a disclaimer of opinion. Practices should exercise their judgment to decide which type of modified opinion is appropriate by considering the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements.

- Practices did not document justifications for issuing modified opinions in working papers.

  Practices should document clearly their reasoning and judgments made in determining the type of opinion, for example, whether an adverse opinion or a disclaimer of opinion should be expressed instead of a qualified opinion. It is crucial for Practices to update documentation on file to reflect any change of their view after considering the appropriateness of the opinion.

*10. Audit of listed companies*

In this second cycle of reviews, most Practices which we had inspected previously continued to maintain or improve their quality control systems, demonstrating their commitment to independence and quality audits. However, there are still a number of important areas that Practices should pay attention to:

- Client acceptance and continuance

  In general, Practices have established policies and procedures for client acceptance and continuance. However, we remain critical of the extent to which some Practices have exercised appropriate professional skepticism when accepting new clients or making engagement continuance decisions, particularly on high risk listed audit clients. For some cases, documentation on files did not demonstrate that a rigorous assessment of client and fraud risk had been carried out by Practices. As mentioned in past reports and forums, Practices should exercise extra caution when accepting a client where there has been a modified audit opinion, a regular change of auditor and negative media portrayal, as such circumstances could be indicative of potential engagement risks. Practices should consider whether they have sufficient expertise and resources to handle a listed company audit engagement before accepting the appointment.

- Independence

  Fee dependence is still an issue for smaller Practices with one or few large listed clients. Practices are reminded that the Code provides that if total fee income from a listed client and its related entities represents more than 15% of total fees received by a Practice for two consecutive years, the Practice should disclose this fact to those charged with governance of the listed client and consider what safeguards, such as external pre-issuance review and/ or post-issuance review of audit engagements, can be applied to reduce the threat to an acceptable level. Practices must consider not accepting or resigning from the engagement if no appropriate safeguards can be put into place.

- Engagement quality control review

  Practices should be well aware that, under HKSQC 1 (Clarified), all listed company audits require an engagement quality control ("EQC") review. Nevertheless, some Practices still considered EQC review primarily as a compliance task e.g. only completed an EQC review checklist with "tick" marks. We reviewed many listed company audits and raised concerns about the lack of evidence of EQC reviews. For some smaller Practices with one or few listed clients, we had cause for concern about the effectiveness of EQC review given the:

  - number of practice review findings about audit engagements that did not have sufficient and appropriate audit evidence to support the work done and conclusions reached on key judgment or risk areas;

  - role of EQC reviewer was delegated to junior managers who may lack the required experience to perform an effective review and may shy away from challenging audit partners when they encounter "issues";

- lack of documentation on audit files to demonstrate the involvement of EQC reviewer during the whole audit process; and
- insufficient documentation to evidence EQC review relating to critical audit issues raised or discussed.

To manage audit risks of clients, EQC review is an important element of quality control to ensure all appropriate audit work is carried out and properly recorded before the opinion is issued. To ensure this quality control function is effective, it is crucial that EQC reviewer is involved throughout the audit process. EQC review's evaluation of the work performed and conclusions reached by the audit team on significant judgment and risk areas should be sufficiently and appropriately evidenced on audit files. Leaders of all Practices need to reinforce this message to audit partners and EQC reviewers to ensure EQC reviews are carried out robustly.

An instance was identified where a partner served a listed client as EQC reviewer and audit partner for eight consecutive years which was considered to be non-compliant with the Code. Practices are reminded that when the role of a partner changes from one to another for the same audit client, the change should not be counted as a fresh start. Accordingly, the years of service on the second role should be added to the years accumulated in the first role, with the total being measured against the rotation limit of seven years or other applicable rotation limits.

### *11. Audit of insurance brokers*

In our previous reports, we have identified common findings on audits of regulated clients, namely securities brokers and non-life insurers. This year, we would like to share common issues identified in audits of insurance brokers, another type of regulated client which we expect Practices to recognize as higher risk and specialized audits.

- Letters of engagement and representation

  There were no formal terms of engagement or written representation from management to address the specific requirements of compliance reporting.

- Professional indemnity insurance

  Instances were noted where Practices did not assess the sufficiency of indemnity insurance coverage in accordance with PN 810.1 *Insurance brokers - Compliance with the minimum requirements specified by the Insurance Authority under sections 69(2) and 70(2) of the Insurance Companies Ordinance*. Some Practices only filed a copy of an indemnity insurance policy as documentation of compliance work and did not evaluate whether the minimum level of professional indemnity was met.

  The Insurance Companies Ordinance ("ICO") requires an insurance broker to maintain a professional indemnity insurance policy with a minimum limit of indemnity for any one claim and in any insurance period of twelve months. The amount of cover is determined with

reference to insurance brokerage income. If, as a result of any claim, the indemnity available falls below the minimum amount, the insurance broker shall effect a reinstatement.

Practices are reminded that when their client joins a professional indemnity insurance plan with other companies and shares maximum claims with others, they should check whether there are any claims from other companies during the reporting period which require their client to reinstate its cover to meet the minimum requirement under ICO. Any non-compliance with the requirement would result in a qualified opinion in the compliance report.

- Keeping of separate client accounts

  Some Practices believed that substantive transaction tests on insurance premiums and costs would be sufficient to satisfy the requirements of compliance reporting. However, we consider that these standard audit procedures do not necessarily provide sufficient assurance on compliance with minimum requirements concerning keeping of client monies. Additional work procedures are required, for example, to ascertain that transactions made through client accounts fall within the permitted deposits and withdrawals as defined in the Guidelines issued by the Insurance Authority. A review of reconciliation between monies in the client account and client's debtors and creditors balances should also be performed at the balance sheet date and two other dates to establish whether the client keeps client monies in an account separately from its own monies and whether client monies were used for any purposes other than for the purposes of their customers.

  Practices are reminded that any omission of work suggested in PN 810.1 might affect the audit opinion and are advised to follow procedures to ensure that sufficient and appropriate procedures are performed to support the compliance opinion given.

- Documentation

  Some Practices did not properly document their work e.g. the extent of work done and the details of samples selected to check whether client monies were used for the purposes of the client and whether withdrawals from a client account were drawn according to the client's written authority. Some Practices simply completed the suggested procedures in PN 810.1 using a "tick-box" approach without providing any details of test samples. When we enquired further about details of work performed, audit teams were sometimes not able to explain what work had been carried out which caused concerns about whether audit procedures had been properly performed.

## Our findings

*Professional standards monitoring programme*

This section highlights more significant or common financial reporting issues identified from reviews of financial statements of Hong Kong listed companies and provides examples illustrating deficiencies in the application of financial reporting standards. We hope that this will be useful information for members to develop a better understanding of the application of the Standards in preparing financial statements in future.

In 2012, the QAD continued to identify deficiencies in application of the following Standards:

(i) HKFRS 7 *Financial Instruments: Disclosures*

(ii) HKFRS 8 *Operating Segments*

(iii) HKAS 1 (Revised) *Presentation of Financial Statements*

(iv) HKAS 7 *Statement of Cash Flows*

(v) HKAS 36 *Impairment of Assets*

Except for HKAS 36, the other HKFRSs listed above are presentation and/or disclosure Standards. The QAD often noted that members omitted to disclose the information required by these Standards or did not properly follow the Standards to present the financial statements. For example, with regard to the application of HKAS 7, the Standard requires that the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency should be reported separately in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. However, the QAD often noted that such effect of exchange rate changes was either omitted or inappropriately determined in the consolidated statement of cash flows.

As compared to the other Standards, HKAS 36 sets out comprehensive recognition and measurement requirements on how an entity should perform impairment assessment of its assets (other than those outside the scope as set out in HKAS 36 paragraph 2). HKAS 36 requires that impairment loss shall be recognized in profit or loss when the asset's carrying amount is greater than recoverable amount and therefore will have a direct impact on the financial position or performance of the entity. However, some instances showed that the impairment assessment might not be properly performed and therefore impairment loss recognized might be misstated. Members should be mindful that using inappropriate assumptions (e.g. discount rate, growth rate and expected future cash flow projections) will come up with an incorrect recoverable amount and consequently affect the conclusion of the impairment assessment. If there is an impairment, both value in use and fair value less costs to sell, should be calculated to determine the higher to be taken as the recoverable amount unless no reliable estimate of fair value less costs to sell is available and in which case recoverable amount is measured by reference to value in use only. The QAD occasionally noted that recoverable amounts were only based on value in use without giving consideration to the fair value less costs to sell. This

had caused concerns about whether the impairment loss recognized has been overstated.

Members are advised to refer to the following links available in the Institute's website to learn more about the above five Standards:

Educational publications (QAD annual reports and Financial and Auditing Alerts):

http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/professional-standards-monitoring/publications-reference/

E-seminar of CPD Learning Resource Centre (Joint Forum with the FRC and HKEx):

http://www.hkicpa.org.hk/en/cpd-and-specialization/cpd/cpd-and-learning-resource-centre/online-courses/e-seminars/available-courses/

### *Section I – Initial application of new and revised financial reporting standards*

In the 2012 reviews, the QAD noted that the new and revised financial reporting standards that are effective for annual periods commencing from 1 January 2011 are either not relevant to a majority of financial statements reviewed or do not have a significant impact on those financial statements where the new and revised standards are applied.

The QAD however would like to remind members that HKFRS 10 *Consolidated Financial Statements*, HKFRS 11 *Joint Arrangements*, HKFRS 12 *Disclosure of Interests in Other Entities* and HKFRS 13 *Fair Value Measurement*, together with the consequential amendments to HKAS 28 *Investments in Associates* and HKAS 27 (Revised) *Consolidated and Separate Financial Statements*, are effective from annual periods beginning on or after 1 January 2013. These Standards may have a significant impact on an entity's financial statements. For example, HKFRS 10 changes the definition of control and replaces the portion of HKAS 27 (Revised) that addresses control and accounting for consolidation. Accordingly, identification of a subsidiary under HKFRS 10 might be different compared to the previous treatment under HKAS 27 (Revised). Members should therefore consider the implications of each of the new Standards on accounting treatments and disclosures.

Members are also reminded to pay attention to the specific transitional requirements on initial application of the above Standards. With regard to initial application, members should also follow the *Amendments to HKFRS 10, HKFRS 11 and HKFRS 12: Consolidated Financial Statements, Joint Arrangements and Disclosure of Interests in Other Entities: Transition Guidance* which were issued in July 2012. The effective date of the Amendments is annual periods beginning on or after 1 January 2013, which is aligned with the effective date of HKFRS 10, HKFRS 11 and HKFRS 12. The Amendments clarify the transition guidance in HKFRS 10 and provide additional transition relief in HKFRS 10, HKFRS 11 and HKFRS 12 which includes limiting the requirement to provide adjusted comparative information to only the preceding period and removing the requirement to present comparative information for disclosures related to unconsolidated structured entities for periods before HKFRS 12 is first applied.

Further amendments to HKFRS 10, HKFRS 11 and HKFRS 12 were issued in December 2012. Such

"Investment Entities" amendments introduced an exception to the principle that all subsidiaries shall be consolidated. The Amendments define an investment entity and require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments* instead of consolidating the subsidiaries. The Amendments also set out disclosure requirements for investment entities. The Amendments are effective from 1 January 2014 with early adoption permitted in order to allow investment entities to apply the Amendments at the same time when they first apply the rest of HKFRS 10.

## *Section II – Topical issues*

1. Accounting for government grants

   Some reporting entities recorded significant grants, subsidies or compensation from government as income. However disclosures relating to such "income" were limited and therefore enquiries were made with the auditors concerned to obtain an understanding of whether the above items were properly accounted for under HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance.*

   Under the general principles stated in HKAS 20 paragraph 7, a government grant is not recognized (i) until there is reasonable assurance that the entity will comply with the conditions attaching to it and (ii) the grant will be received. Receipt of a grant is not itself conclusive that the conditions attaching to the grant have been or will be fulfilled. An entity should consider the nature of government grant conditions and obligations in determining the basis for recognition. Members may refer to HKAS 20 paragraphs 17 to 21 for more guidance.

   In respect of government loans at below-market rate of interest, HKAS 20 which was amended as a part of *Improvements to HKFRSs* issued in October 2008, provides relevant guidance. HKAS 20 paragraph 10A requires that the "benefit" of a government loan at a below-market rate of interest is treated as a "government grant". The loan shall be recognized and measured in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with HKAS 39 and the proceeds received. The benefit is then accounted for in accordance with the abovementioned general principles and other relevant applicable guidance provided in HKAS 20 (i.e. related to depreciable assets or related to income). The entity shall consider conditions and obligations that have been, or must be, met when determining the accounting treatment for the benefit of the loan. In a case reviewed, the QAD noted that the reporting entity received interest-free loans, which would mature ten years from the borrowing dates, from a government entity. In view of the lack of disclosures, we raised enquiries asking the auditor to clarify the accounting treatment of the loans. Given the potential variability of accounting treatments, it is important to ensure that adequate disclosures are made in the financial statements to support the treatment applied.

2. Earnings per share ("EPS")

HKAS 33 *Earnings per share* applies to entities whose ordinary shares or potential ordinary shares (such as convertible bonds, options and warrants) are publicly traded. HKAS 33 specifies principles for the determination and presentation of EPS so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity. Therefore EPS is an area that is of particular relevance and importance to listed companies. In view of the public interest nature of listed companies, members should ensure that EPS is properly calculated in accordance with HKAS 33.

In last year's report, we analyzed deficiencies in three main areas, "Impact of subsequent events on EPS calculation", "Calculation of the weighted average number of shares as denominator for the EPS calculation" and "Calculation of diluted earnings per share". The 2012 reviews continued to identify similar issues as members had either provided insufficient disclosures or not given proper considerations to the dilution effect of instruments issued by the company in calculating diluted EPS. The following were typical examples:

(i) HKAS 33 requires that the calculation of diluted EPS only takes into account of potential changes to the number of shares that would reduce earnings per share or increase loss per share (i.e. dilutive effect). It does not include potential changes which would increase EPS (i.e. anti-dilutive effect). The numerators used in the calculation of basic and diluted EPS should be reconciled to profit or loss attributable to the ordinary equity holders of the parent (HKAS 33 paragraph 70(a)). The denominators in the calculations of basic EPS and diluted EPS should be reconciled to each other (HKAS 33 paragraph 70(b)).

However the reconciliation tables disclosed in some financial statements raised doubts on whether the reporting entities had properly followed the relevant guidance under HKAS 33 in determining what items should be included in the diluted EPS calculation. For example, some reporting entities incorrectly included the effect of anti-dilutive potential ordinary shares from convertible bonds in diluted EPS calculation. We noted that inclusion of the effect of relevant convertible bonds (i.e. the relevant imputed interest and number of potential ordinary shares) will reduce the diluted loss per share.

(ii) Some reporting entities issued warrants or share options during the year but the warrants or share options had not been included in the calculation of diluted EPS. Accordingly, there is a presumption that the warrants or share options were anti-dilutive. HKAS 33 paragraph 70(c) requires the entity to disclose instruments that could potentially dilute basic EPS in the future, but were not included in the calculation of diluted EPS because they are anti-dilutive for the period(s) presented. However, for some instances, the reporting entity did not make such a disclosure.

(iii) In a few other cases, the reporting entities omitted to disclose diluted EPS.

3. Convertible instruments

Issuance of convertible instruments is a prevalent practice in the Hong Kong capital market. We discussed some common issues in our 2010 QAD report. However as there are recurring and other significant application issues noted in 2011 and 2012, we consider that there is a need to remind members of the key requirements of the relevant Standards and the appropriate application.

(i) Accounting for early redemption option

In the 2010 QAD report, we explained the relevant guidance provided in the Standards that the entity needs to consider in determining the accounting treatment of early redemption option embedded in convertible instruments issued by the entity. Depending on the agreement between the issuer and the bondholders, such option may be a put option held by the bondholders to require the issuer to redeem the bonds early, or a call option exercisable by the issuer to early redeem the bonds before maturity dates. We identified that occasionally companies had not fully complied with the relevant guidance in the following two major aspects:

(a) Recognition issue

Some auditors' responses to our enquiry letters simply explained that, based on management's representation, it was unlikely that the early redemption option will be exercised by bondholders. There were also responses which explained that the issuer (the listed company) did not recognize the early redemption option because it did not intend to early redeem the bond. As a result, the auditors concurred with management's view that the early redemption options (no matter whether held by the bondholders or the issuer) had no value for recognition.

Such considerations are not sufficient to support the view that recognition of the early redemption option was not needed. First and foremost, management's expectation or intention about the exercise of the option is not relevant to justify the measurement (see more discussion in (b) below) and accounting treatment of an early redemption option. To determine the recognition of the early redemption option, an entity needs to assess whether the early redemption option, as an embedded derivative, is closely related to the host debt instrument in accordance with the relevant guidance in HKAS 39 paragraph 11 and AG30(g). If the early redemption option is not closely related, separate recognition is needed and the accounting will be the same as for a standalone derivative, unless the entity chooses to designate the entire instrument at fair value through profit or loss in accordance with HKAS 39 paragraph 11A or is required to do so in accordance with HKAS 39 paragraph 12.

Therefore, simple reliance on management's representation about its expectation or intention about the early redemption option being exercised might lead to omission of the recognition of an embedded derivative or inappropriate accounting treatment of the entire instrument.

(b) Measurement issue

As required by HKAS 39 AG75 and AG76, the factors and inputs used in a valuation model should be from the perspective of market participants and represent market expectation. Therefore management's expectation or intention is not relevant in determining the fair value of the early redemption option. Even if management has no expectation or intention about the option being exercised, this does not mean that the option in itself had no value from the market perspective. Determination of the fair value of the early redemption option should be based on market information and professional valuation may be needed to determine the fair value.

Convertible instruments might contain other embedded derivatives apart from an early redemption option. Members should go through the same considerations as explained above to ensure that they are properly accounted for in the financial statements.

(ii) Consideration of clauses provided in the original, or supplementary, agreements in relation to subsequent adjustments to conversion price and number of conversion shares

It is not uncommon that certain adjustment clauses are set out in convertible instrument agreements whereby the number of conversion shares and the conversion price might be adjusted when specified circumstances occur. There are also situations where subsequent adjustments are made to the terms of convertible instruments according to supplementary agreements between an issuer and the bondholders.

In one case reviewed, the disclosures mentioned that more than one adjustment had been made to the conversion price of a convertible bond issued by the reporting entity. Given that there was no mention of the reason for the subsequent adjustments to the conversion price, it was unclear whether the adjustments had been properly considered in accounting for the convertible bond. The financial implications of such adjustments should be assessed. The following are some examples of situations that entities may encounter and the relevant considerations that should be made in assessing the financial implication in those situations. Members are reminded that the determination of an appropriate accounting treatment should be based on the specific facts and circumstances of each individual case with appropriate judgment being exercised.

- The nature of the adjustments must be understood, for example whether

they are anti-dilutive provisions for protecting the economic rights of the bondholders when certain events occur. If these adjustments are not made for anti-dilutive purposes or would not achieve such a purpose, members should consider whether the "fixed for fixed" notion under HKAS 32 *Financial Instruments: Presentation* might be unfulfilled in the first place given that the conversion price and thus the number of shares that will be obtained on conversion would vary depending on the future contingent adjustments.

In response to one QAD enquiry the auditor explained that it had obtained management's confirmation that the "adjustments" to conversion price were under the control of management and of no value to the company and therefore had no significance to the assessment of compliance with the "fixed for fixed" notion. Reliance on management's representation alone is not sufficient to justify that the "adjustments" to conversion price would not lead to violation of the "fixed for fixed" notion on initial recognition of convertible bonds. We expect that members would take steps to understand how the "adjustments" would operate should specified situations occur and assess whether the outcome of adjustments would give results that preserve the relative economic rights of shareholders and bondholders, that is, they achieve their anti-dilutive purpose.

If the "fixed for fixed" notion is not fulfilled, the convertible instrument should be accounted for as financial liabilities under HKAS 32 and subject to HKAS 39 for recognition and measurement.

- If subsequent adjustments are due to a new agreement between the issuer and the bondholders, say, to induce early conversion, for example by offering a more favorable conversion ratio (e.g. reduction of conversion price) or paying other additional consideration in the event of conversion before a specified date, the issuer should apply HKAS 32 AG35 (assuming the "fixed for fixed" notion is met and the bond has been split into its debt and equity components). At the date the terms of the convertible bond are amended, HKAS 32 AG35 requires that the difference between the fair value of the consideration the holder receives on conversion of the instrument under the revised terms and the fair value of the consideration the holder would have received under the original terms is recognized as a loss in profit or loss. Members may refer the illustrative example provided in HKAS 32 IE47 to IE50 for a better understanding of the accounting treatment.
- There might be situations where a subsequent amendment, for example a change in a convertible bond's maturity date and a commensurate change in its interest rate, is determined to be a substantial modification under the

provisions of HKAS 39 paragraphs 40 to 42 and AG62 resulting in it being accounted for as an extinguishment of the original bond and the recognition of a new bond. If the transaction is determined to be, in substance, a repurchase of the existing bond by issuing a new convertible bond with the original conversion privileges remain unchanged, the issuer would account for the change in accordance with HKAS 32 AG33 and AG34. Accordingly, the consideration paid, being the fair value of the new convertible bond, and any transaction costs are allocated to the liability and equity components of the existing bond at the date of the transaction. The difference between the consideration allocated to the liability component of the existing bond and its carrying amount is recognized in profit or loss.

- In other circumstances where there is no change to the conversion privileges, HKAS 39 paragraphs 40 to 42 and AG62 may indicate that the modification made to the existing bond is not substantial. HKAS 39 AG62 states that, terms are considered to be substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability. Where the result does not exceed 10 percent, the change is accounted for as a modification. The equity component remains unchanged and any costs or fees incurred adjust the carrying amount of the liability and are amortized over the remaining term of the modified liability.

- In practice, in addition to the 10 percent quantitative test, entities may consider qualitative factors to be relevant for determining whether the modification of terms is substantial. However, there is no explicit guidance in HKAS 39 as to how the qualitative factors are to be assessed for the purpose of determining whether the modification is substantial or not.

Modification of terms of convertible bonds is a complex area in financial reporting. As each case involves different complexities, the determination of an appropriate accounting treatment should be based on thorough considerations of the specific facts and circumstances of each case. For example, in a case where the components of a convertible bond are inter-dependent, a change of the terms of one component may have repercussions on the other components. Therefore members should be mindful of potential consequential accounting impacts on other inter-related components when one component is modified and carefully account for each change in accordance with all the relevant requirements of the Standards.

*Section III – Disclosures deficiencies*

This section addresses some disclosures in respect of HKAS 12 *Income Taxes*, HKFRS 2 *Share-based Payment*, HKAS 24 (Revised) *Related Party Disclosures*, HKAS 21 *The Effects of Changes in Foreign Exchange Rates* and HKAS 10 *Events after the Reporting Period* often omitted from financial statements. Questions were frequently raised because of omission or unclear disclosures provided in the financial statements. Disclosures made should be fact-specific, clear and sufficient to allow users to understand the impact of events or transactions on the entity's financial position and performance. Common disclosure deficiencies of the above Standards are summarized below:

1. Income Taxes

   The following disclosures were often missing from the financial statements:

   - Amount of income tax relating to each component of other comprehensive income where relevant;
   - Nature of deferred tax assets and liabilities recognized;
   - Explanation of changes in applicable tax rates compared to the previous accounting period and the amount of deferred tax expense (income) relating to changes in tax rates;
   - Amounts and expiry dates of related deductible temporary differences and unused tax losses for which no deferred tax asset is recognized e.g. tax effects of unrecognized deductible temporary difference and unused tax losses were included in the reconciliation between tax expense and accounting profit but no other disclosures were made;
   - Explanation of why deferred tax liabilities have not been recognized on undistributed profits and the aggregate amount of temporary differences associated with undistributed profits of subsidiaries for which deferred tax liabilities have not been recognized e.g. it is often noted that the entity's principal subsidiaries operate in overseas locations such as Mainland China and segment information indicated that the subsidiaries were profit generating, however the above disclosures were not provided;
   - Key assumptions and key sources of estimation uncertainties involved in determining whether deferred tax assets should be recognized;
   - Description of circumstances in which the deferred tax assets and liabilities can be offset; and
   - Description of nature of reversal of significant overprovision of tax expenses in prior year.

*Amendments to HKAS 12 Deferred Tax – Recovery of Underlying Assets* is effective for annual periods beginning on or after 1 January 2012. The amendments introduce an exception to the general principles in HKAS 12 in that deferred tax arising on investment property carried at fair value under HKAS 40 *Investment Property*, shall be measured presuming the carrying amount of the investment property is to be recovered through sale.  Members are

reminded to disclose the impact on the financial statements of the initial application of the Amendments to HKAS 12 as required by HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

2. Share-based Payment

   The following information in relation to share-based payment arrangements was often found to be superficial or missing:

   - Terms and conditions of each arrangement, such as vesting requirements, the contractual life of options granted, and the method of settlement e.g. vesting of share options is subject to the performance of the group but the details of these conditions (i.e. market conditions or non-market conditions) were not disclosed;
   - Number and weighted average exercise prices of share options exercisable at the end of the period;
   - Weighted average share price at the date of exercise for share options exercised during the period;
   - Range of exercise prices and weighted average remaining contractual life for share options outstanding at the end of the period;
   - Explanation of modifications made to or cancellation of share options scheme;
   - Accounting policy in relation to cancellation of share options granted and for situations where equity instruments are granted to acquire assets or services from other parties; and
   - Fact and explanation of why the presumption that the fair value of goods or services received from parties other than employees such as consultants and advisors can be estimated reliably was rebutted. For cases where the presumption was rebutted, there was no explanation provided of why share options were measured at fair value of the equity instruments at grant date but not at the date the entity obtains the goods or the counterparty renders service.

3. Related Party Disclosures

   Disclosures that are often found to be insufficient or omitted include:

   - Name of the parent of the entity and, if different, the ultimate controlling party;
   - Separate disclosures should be made for different categories of related parties, including but not limited to the parent, associates, joint ventures and key management personnel;
   - Amount of key management personnel compensation did not include the remuneration of non-executive directors and was not disclosed under the categories of (a) short-term employee benefits; (b) post-employment benefits; (c) other long-term benefits; (d) termination benefits; and (e) share-based payment; and
   - Name of the government and nature of its relationship with the entity (i.e. control, joint control or significant influence), nature and amount of each individually significant transaction, and a qualitative or quantitative

indication of the extent of effect of the transactions on the financial statements if the transactions are collectively, but not individually, significant, if the entity applies the exemption of HKAS 24 paragraph 25 which was effective for annual periods beginning on or after 1 January 2011.

4. The Effects of Changes in Foreign Exchange Rates

   The following information was frequently not disclosed in the financial statements:

   - Functional currency of the parent, and if it is different from the presentation currency, the reason for using a different presentation currency;
   - Amount of exchange differences recognized in profit or loss e.g. significant monetary items such as trade receivables and payables denominated in a foreign currency were shown in the financial statements but no exchange difference was recognized in profit or loss; and
   - Accounting policies in respect of a disposal of a foreign operation, and the translation of goodwill and fair value adjustments on identifiable assets and liabilities acquired arising on an acquisition of a foreign operation.

5. Events after the Reporting Period

   Details of acquisition and disposal plans made subsequent to the reporting period disclosed in the Chairman's Statement and management discussion and analysis are not supported by disclosures, including the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made about these events in the notes to the financial statements.

The QAD would like to emphasize that adequate disclosures required by Standards that are of value and useful to users of the financial statements should be provided in the financial statements.

## Communications with members

The results of both programmes are used to assist members to improve their understanding and application of professional standards and raise the quality of auditing and financial reporting. Common issues found under the review programmes were communicated to members through different channels:

- The QAD hosted two forums in June and September 2012 that attracted a combined audience of approximately 440. The forums covered educational points identified from both programmes and discussed common auditing issues that practitioners encountered in complying with professional standards. A webcast of the forum was made available in December 2012.

- In November 2012, the QAD organized a joint forum with the FRC and HKEx which drew approximately 280 attendees. Common issues identified from the review programmes of financial statements of Hong Kong listed companies carried out by the three bodies were presented.

- The Executive Director, Director of the QAD and representatives of the PRC attended the SMP Symposium held on 30 November 2012 to discuss common practice review findings and recommendations with practitioners in small and medium practices.

- Issues on professional skepticism and audit of Mainland companies were covered in a Financial and Auditing Alert in 2012.

Findings from the reviews have also been used by the Institute's technical team in providing relevant support for members through ongoing training sessions.

## Members of the Standards & Quality Accountability Board in 2012

| Name | Position | Company |
|---|---|---|
| Mr. BEST, Roger Thomas | Chairman | |
| Mr. CHONG, Kim | Member | Hong Kong Monetary Authority |
| Mr. GRIEVE, Charles Ramsay | Member | Securities & Futures Commission |
| Mr. KENNEDY, Paul | Member | |
| Ms. CHEUNG, Wing Han, Ivy (Appointed 31 January 2012) | Member | KPMG |
| Mr. LAM, Wai Man, Frankie | Member | The Treasury, HKSAR |
| Mr. WONG, Tat-cheong, Frederick | Member | Audit Commission, HKSAR |

## Members of the Practice Review Committee in 2012

| Name | Position | Company |
|---|---|---|
| Ms. CHAN, Mei Bo, Mabel | Chairman | Mabel Chan & Co. |
| Mr. GEORGE, Richard John Weir | Deputy Chairman | Deloitte Touche Tohmatsu |
| Mr. CHENG, Kin Chung | Member | Poly Genius Consulting Limited |
| Ms. CHEUNG, Yuk Ting, Mabel | Member | PricewaterhouseCoopers |
| Mr. CROWE, William Andrew | Member | KPMG |
| Mr. FAN, Chun Wah, Andrew (Appointed 31 January 2012) | Member | C.W. Fan & Co. |
| Mr. FUNG, Hon Kwong, Tommy (Appointed 31 January 2012) | Member | Ernst & Young |
| Ms. FUNG, Yee, Pammy | Member | Crowe Horwath (HK) CPA Limited |
| Mr. HON, Koon Fai, Alex | Member | HLB Hodgson Impey Cheng |
| Ms. KWOK, Yuen Man, Eunice | Member | Mazars CPA Limited |
| Mr. POON, Tsun Wah, Gary | Member | Poon & Co. |
| Mr. TAM, King Ching, Kenny | Member | Kenny Tam & Co. |
| Ms. TANG, Kwan Lai | Member | SHINEWING (HK) CPA Limited |
| Ms. YAM, Hoi Yin, Cecilia | Member | BDO Limited |
| Mr. YAU, Yin Kwun, Joseph (Appointed 31 January 2012) | Member | C K Yau & Partners CPA Limited |

## Members of the Professional Standards Monitoring Expert Panel in 2012

| Name | Company |
|---|---|
| Mr. CHENG, Chung Ching, Raymond | HLB Hodgson Impey Cheng |
| Ms. CHEUNG, Sau Ying, Olivia | Hong Kong Exchanges and Clearing Limited |
| Mr. CHOW, Siu Lui, Jack | VMS Investment Group |
| Mr. DEALY, Nigel Derrick | PricewaterhouseCoopers |
| Mr. HEBDITCH, Paul Donald (Appointed 31 January 2012) | Ernst & Young |
| Mr. HO, Che Kong, John | Leighton Asia Limited |
| Ms. HO, Man Ching, Elsa (Stepped down 25 September 2012) | Mazars CPA Limited |
| Ms. HSIANG, Yuet Ming, Fanny | BDO Limited |
| Mrs. MORLEY, Catherine Susanna (Appointed 31 January 2012) | KPMG |
| Mr. TAYLOR, Stephen | Deloitte Touche Tohmatsu |
| Mr. YAN, Yiu Kwong, Eddy | Crowe Horwath (HK) CPA Limited |

*This Annual Report is intended for general guidance only. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this Annual Report can be accepted by the Hong Kong Institute of Certified Public Accountants.*

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