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

Quality Assurance

Report 2013

Content

Foreword

Fellow members

I am pleased to present our report on the quality assurance department's practice review and professional standards monitoring programmes in 2013 and share with you findings identified in those reviews.

In 2013, we started our third 3-year cycle of reviews of practices that audit listed entities and achieved our target of practice review visits.

Starting from our April 2013 practice reviews, we have categorized our findings into significant ones and those that are less so in our review reports in order to focus on the former.

We are disappointed that many initial practice reviews continue to identify common deficiencies that have been repeatedly communicated to members and practices in previous annual reports and forums. This means the number of cases that require follow up action remains high, in particular for practices that do not audit listed entities. The Practice Review Committee believes that this situation is not acceptable and reflects badly on the audit profession in Hong Kong. In order to strike a correct balance between education and regulation, stronger action will have to be taken against practices that fail to take proactive action to prevent those significant deficiencies commonly referred to in publications occurring in their practices.

In 2013, we started making referrals of cross border engagements to the Ministry of Finance ("MOF") in Mainland China for review under our memorandum of understanding that provides for mutual assistance in discharging of our respective regulatory functions. We very much appreciate the assistance provided by the MOF and will maintain our dialogue with the MOF to enhance cooperation and coordination of our review work on cross border engagements.

For professional standards monitoring, during our reviews of listed companies' financial statements, we continued to identify the same shortcomings found in previous years. There were few new areas of concern in 2013 as there has been a period of stability for some time in the world of financial reporting standards. However, 2014 will be a demanding year as a number of new standards on investments with new guidelines on classification and new disclosure requirements for investments have come into effect for financial statements with a December 2013 year end. Significant changes to the financial statements might result from initial application of these new standards that can lead to more issues to be found by our reviewers.

Audit regulatory reform has been a topical issue since the issue of a consultation paper by the Institute in October 2013 seeking members' views on certain proposals for changes to the system of audit regulation in Hong Kong. One proposal is to transfer all or part of the practice review function in respect of practices that audit listed entities from the Institute to an independent oversight body. No decision has yet been made. A public consultation will take place towards the middle of 2014. Regardless of the outcome, the Institute will continue to play a vital role in maintaining the quality of the audit profession.

Finally, I would like to thank all members for their support for our quality assurance programmes. Only with their co-operation, are we able to ensure that our programmes are effective and our aims achieved, which is clearly in the common interests of the profession and Hong Kong.

Elsa Ho
Director, Quality Assurance, Hong Kong Institute of CPAs
March 2014

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. 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 and Practice's response 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, developed primarily using 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 HKSQC1 (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.

Matters identified during a review are fully discussed with the Practice. 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 the 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 217 in 2013.

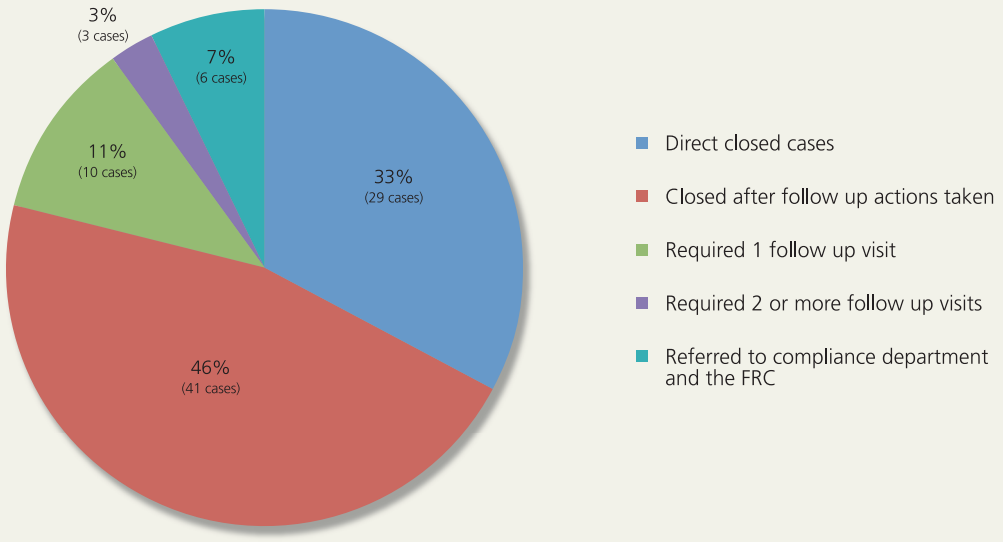
In 2013, the QAD started the third review cycle of all Practices with listed clients and carried out 22 visits and 1 follow up visit on Practices with listed clients.

In 2013, the QAD also referred five cross border engagements to the Ministry of Finance ("MOF") in Mainland China for review under the memorandum of understanding between the MOF and the Institute that provides for mutual assistance in discharging their respective regulatory functions. The MOF's review report and any response from the Practice will form part of the practice review report on the Practice. The Institute very much appreciates the assistance provided by the MOF and will maintain dialogue with the MOF to enhance cooperation and coordination of review work on cross border engagements.

Since the launch of the revised practice review programme in 2007 up to December 2013, the QAD has made 89 reports to the PRC on Practices with listed clients.

For Practices with listed clients 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 a Practice with listed clients as a result of serious non-compliance with professional standards and serious technical failings. That complaint was completed with disciplinary action taken. Two cases are going through disciplinary proceedings. The other two cases are still under investigation by the FRC. The PRC has raised complaints against one Practice with listed clients on the grounds that the Practice did not comply with the Corporate Practices (Registration) Rules. Complaint was concluded in 2014 with disciplinary action taken against the Practice. The PRC has also raised complaints against two Practices with private clients on the grounds of non-compliance with a number of professional standards and the cases are going through disciplinary proceedings.

Practices with listed clients reviewed by QAD since 2007 (based on latest practice review results)

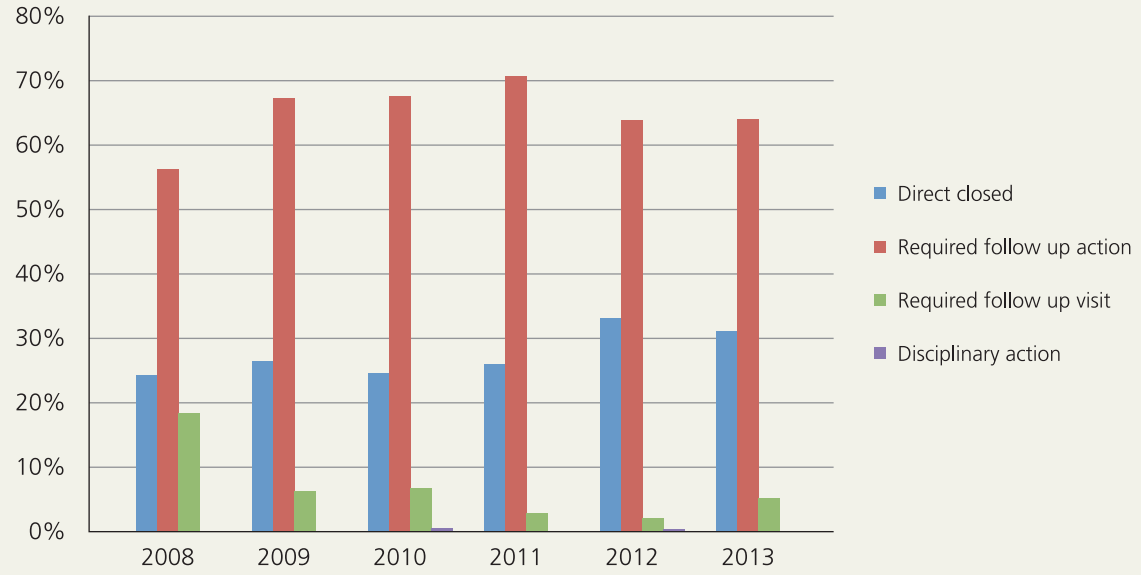


The PRC met on eleven occasions in 2013 and considered reports on 197 Practices. The PRC concluded that 61 cases should be closed without requiring any follow up action. For 126 cases, Practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Ten cases required a follow up visit to assess the effectiveness of remedial actions taken.

In addition to the 197 "first time" practice reviews, 14 follow up visits were reported to the PRC in 2013. Two cases were closed on the basis that adequate remedial actions had been taken, eleven cases required further follow up actions and, one case proceeded to a complaint.

The "first time" practice review cases reported to the PRC which have been directly closed decreased slightly from 33% in 2012 to 31% in 2013. The majority of reviews have continued to require remedial action, follow up visits or even disciplinary action.

Practice review cases reported to PRC (all Practices)

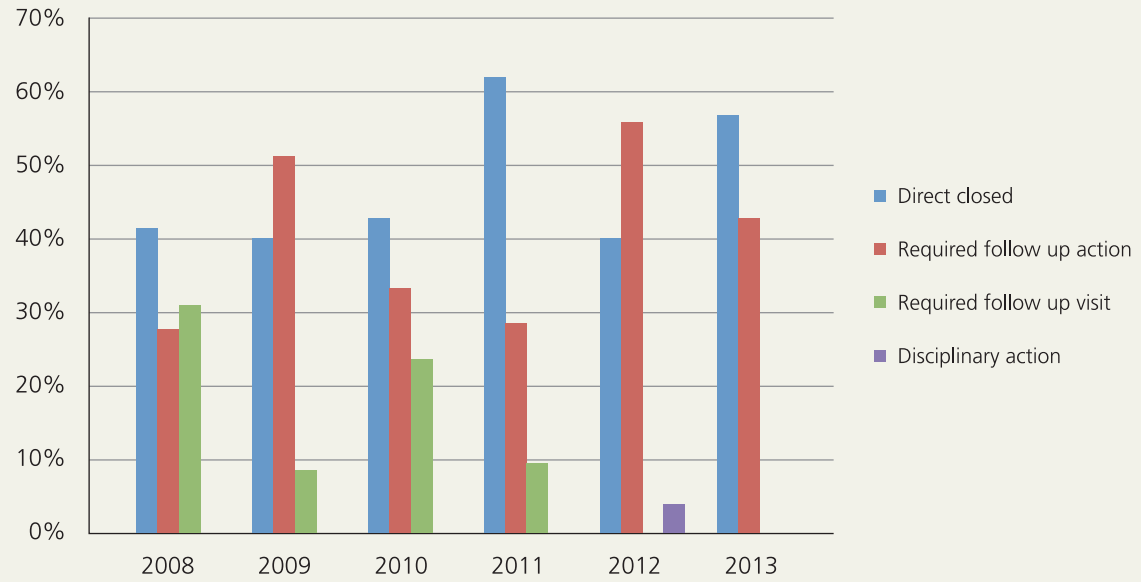


For Practices with listed clients, directly closed reviews have increased from 40% in 2012 to 57% in 2013 while the reviews requiring follow up action have decreased from 56% in 2012 to 43% in 2013. This is encouraging as the outcomes indicate improvement in the quality of Practices with listed clients.

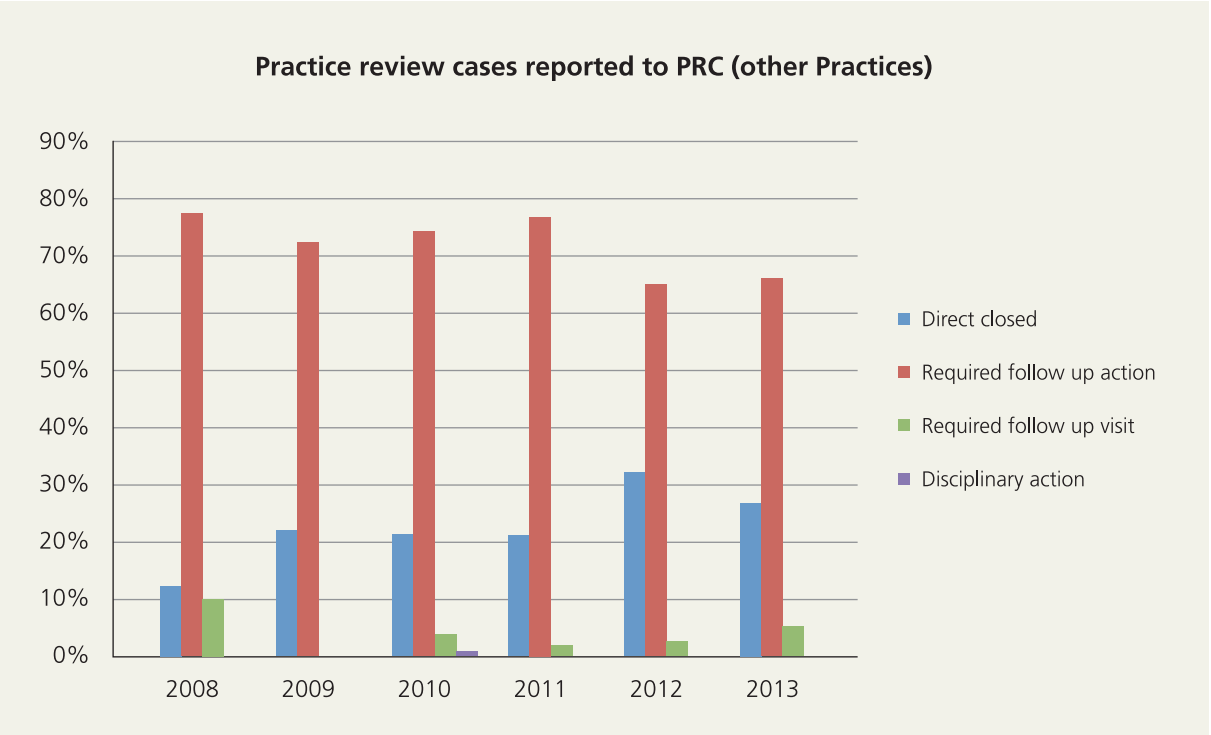
In 2013, the QAD visited five Practices which undertook listed client engagements for the first time. Four of the reviews resulted in the PRC directing follow up action. These five Practices each have only one or a few listed clients.

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.

Practice review cases reported to PRC (Practices with listed clients)



28% of the reviews of other Practices were directly closed in 2013, representing a decrease of 4% from 2012. The cases that required follow up action have remained high at 67%. The results of reviews suggest that the level of compliance with professional standards, especially HKSQC 1 has not significantly improved.



Unsatisfactory responses provided by the Practice to the review report findings may be one of the reasons that a case is not closed directly. 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.

In 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 considered it necessary to take steps to ensure that remedial action was effective in addressing identified weaknesses or to assess the extent of improvement in the quality of the Practice's policies, procedures and audit work.

Where findings identified in a first visit amount to serious professional misconduct or in subsequent visits show that the Practice has still failed to observe, maintain or apply professional standards in a significant way, the PRC may decide to make a complaint against the practising member(s) which may ultimately result in disciplinary action.

Our work and review outcomes – Professional standards monitoring programme

The programme is a non-statutory financial reporting review programme established in 1988 that aims to serve public interest. It monitors compliance with professional standards by members engaged in the preparation or audit of published financial statements. The objective of the programme is ultimately to enhance the quality of financial reporting and the application of professional standards in Hong Kong.

Under the programme, the QAD carries out regular reviews of published financial statements of Hong Kong listed companies and raises enquiries with members (primarily auditors of listed companies) on issues identified from the reviews. If the issues identified are significant, complex or controversial, the QAD will consult with the Professional Standards Monitoring Expert Panel ("Expert Panel") which provides advice on the appropriate course of action for the issues identified. The Expert Panel consists of members from Big Four and medium-sized practising firms, a representative from Hong Kong Exchanges and Clearing Limited ("HKEx") and two non-practising members. Please refer to Annex for composition of the Expert Panel.

The programme is also supported by Big Four and medium-sized practising firms and individual external reviewers. They provide assistance in the conduct of initial reviews of financial statements.

The programme also serves an educational purpose as the QAD gives advice to members on how to improve the quality of financial statements. If there is significant potential non-compliance with 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.

Our work

The QAD issues enquiry letters on matters identified during the reviews which indicate potential non-compliance with professional standards. If there is a lack of disclosures about certain significant events or transactions carried out by a listed company, the QAD will also raise enquiries to obtain information such that the QAD can assess whether there is non-compliance with professional standards. The QAD may also raise enquiries on significant audit issues 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 the issues identified and assist the QAD in arriving at appropriate follow up actions and conclusions. With the strong support of the Expert Panel, the QAD ensures that enquiries made and conclusions reached are appropriate.

The review process can be divided into three stages:

Stage 1 – External review

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

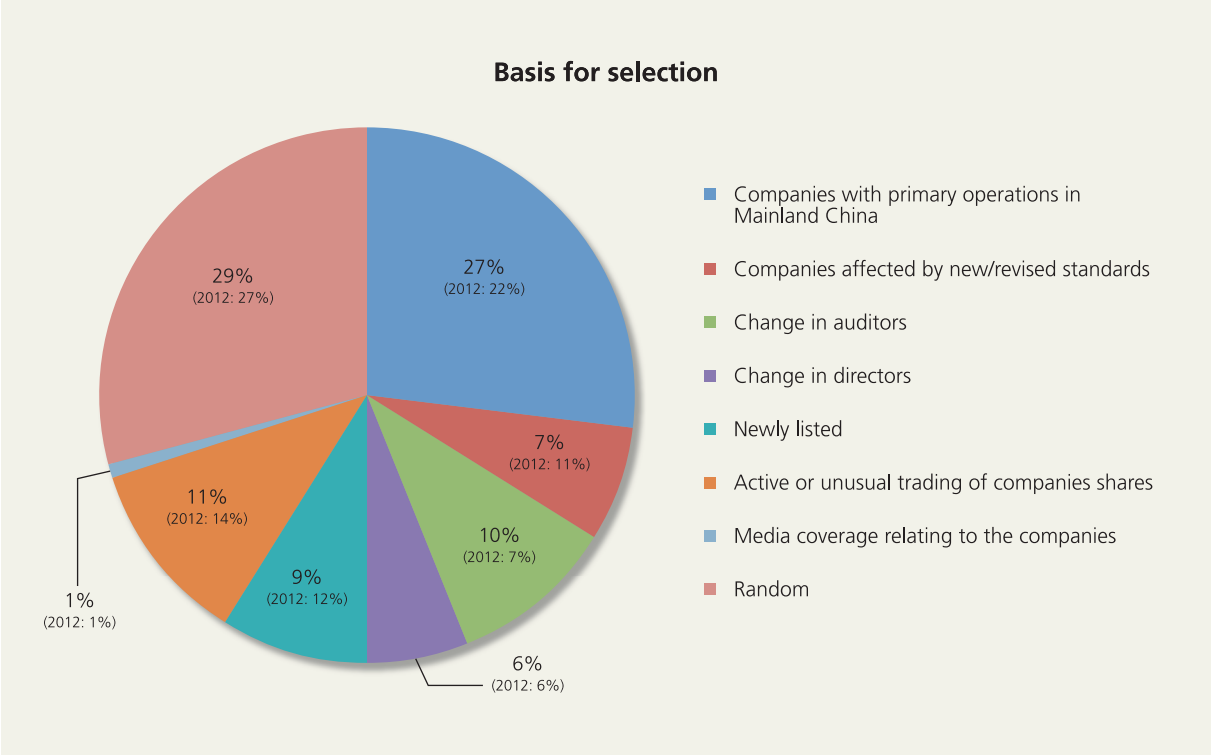
Stage 2 – QAD review

- 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 or other appropriate action is necessary for the case
- The QAD consults the Expert Panel on significant, complex or controversial issues

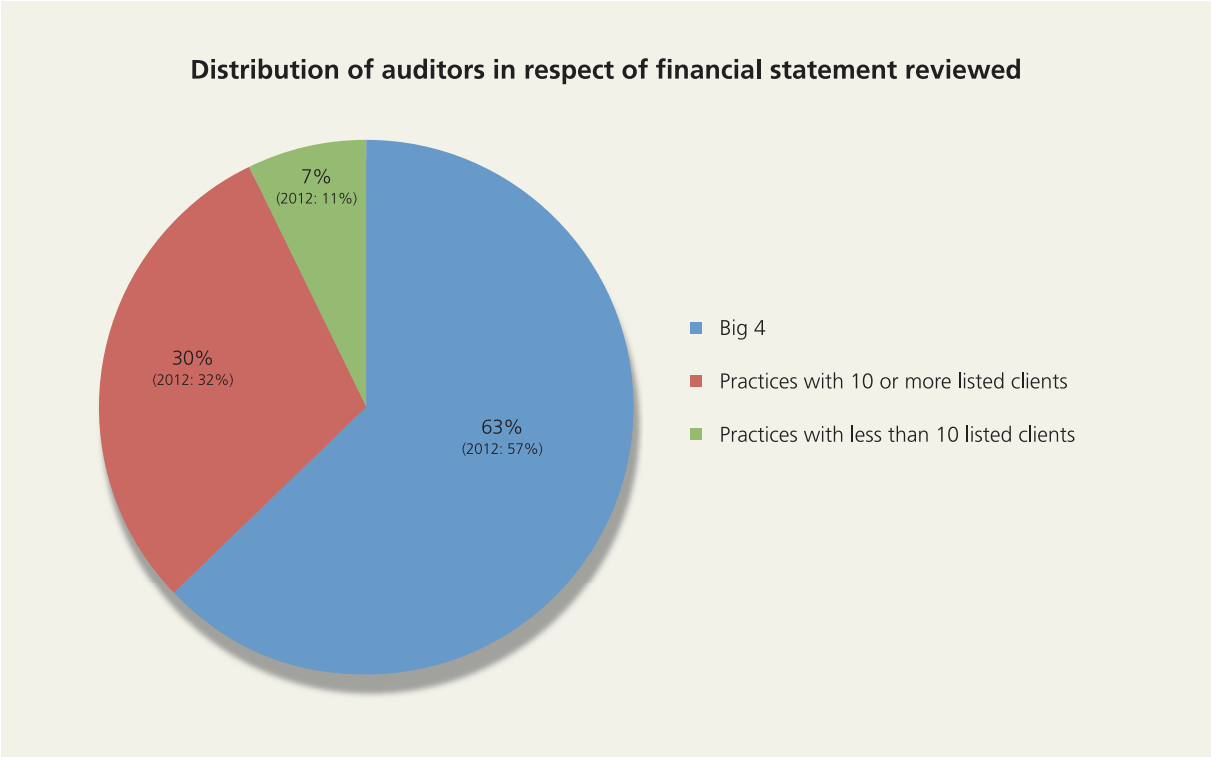
Selection of financial statements for review is risk-based. The following chart shows the basis of financial statements selected for review in 2013.



There were no significant changes in the basis of selection in 2013 as compared to 2012. The increase in reviews of "Companies with primary operations in Mainland China" was due to the fact that the QAD has increased the number of reviews of Hong Kong listed company financial statements which were prepared under Chinese Accounting Standards for Business Enterprises ("CASBE"). There is more information about the reviews of CASBE financial statements in "Our review outcomes".

As for 2012, only a small portion of financial statements reviewed were for "Companies affected by new/revised standards" as only a few new and revised financial reporting standards became effective and the impact on the majority of financial statements was minimal.

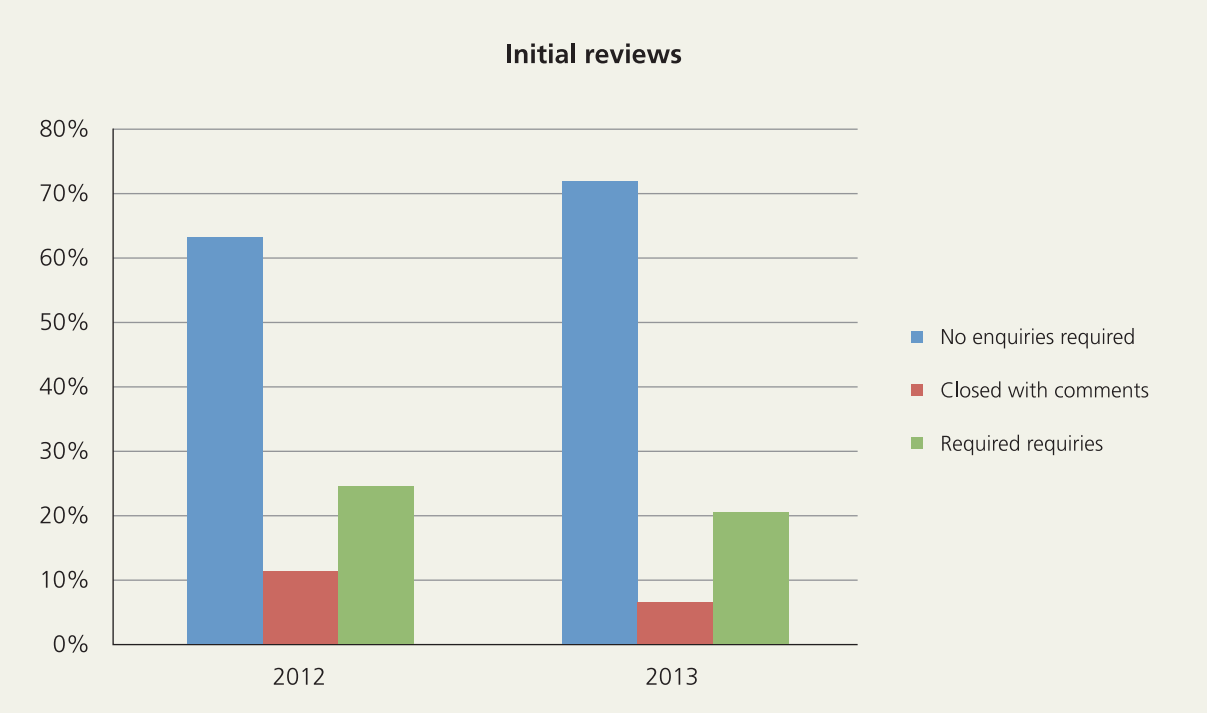
The QAD also considered the proportion of market share of respective auditors in selecting the number of financial statements reviews for auditors. This means auditors which have more listed clients have a higher number of their clients selected. The following chart shows the overall distribution of auditors regarding the financial statements reviewed in 2013:



Our review outcomes

In 2013, the QAD reviewed 86 sets of published financial statements and followed up 8 cases brought forward from the previous year. During the year, the QAD issued 40 letters and handled 24 responses from auditors. Of 87 cases closed, 81 related to financial statements reviewed during the year and 6 were brought forward from the previous year. Of the 2 other brought forward cases followed up during the year, 1 was referred to the FRC and 1 required further follow up actions.

The chart below shows that no follow up action was needed for the majority of financial statements reviewed in 2013.



Referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. The Institute referred 5 cases in previous years and 1 case in 2013 that were identified by the professional standards monitoring programme.

By the end of March 2014, the FRC had completed all investigations on referred cases except the one referred in 2013. Following the FRC investigation, 2 cases were closed 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 financial reporting review programmes to monitor the quality of financial statements of Hong Kong listed companies. The Institute regularly communicates with the other two bodies to avoid duplication of work.

The QAD, the FRC and HKEx share the task of reviewing CASBE financial statements filed with HKEx. There were 37 listed companies (2012: 28) which have opted to use CASBE for preparation of their 2012 financial statements. Between the three organisations, all 37 sets of financial statements were reviewed. The QAD reviewed 12 (2012: 9). There were no significant findings identified from the reviews of CASBE financial statements.

The QAD held the annual joint financial reporting forum with the FRC and HKEx on 20 November 2013. The forum was fully subscribed and attracted approximately 310 attendees. The representatives of the three bodies shared common or significant observations identified from reviews of Hong Kong listed companies' financial statements many of which were included in our 2012 report. The event had been filmed and members can view the video through the e-learning programme of the Institute.

Our findings

Practice review programme

This is the seventh annual report on the revised practice review programme. In 2013, we started our third 3-year cycle of reviews of Practices that audit listed entities. We also achieved our target of practice review visits for 2013, carrying out 217 reviews.

Starting from April 2013, we have categorized our review findings into significant findings and other points for attention in order to draw focus of the readers of our review reports, in particular the Practices and the Practice Review Committee, on the former. Significant findings are findings that may have a more direct or material impact on the quality control system or audit opinion and therefore require special attention of the Practices. This change in reporting style does not affect the number of findings reported in our review reports.

In 2013, we continued to identify common deficiencies that have been regularly found in previous years and communicated to members and practices in publications and events. This suggests that our efforts on education have not been entirely successful, and perhaps it is about time to take stronger action against Practices that fail to take proactive steps to prevent those deficiencies occurring.

This section summarizes major common issues identified from our reviews carried out in 2013. In Section I, we address the five findings that require particular attention. These have been communicated many times in publications and events but are still commonly found in initial practice reviews, particularly of small practices. We expect Practices to pay particular attention to these findings and to take steps to prevent the deficiencies occurring in their practices. We will focus on these areas as a work priority in 2014. Section II sets out common findings on two topical areas, namely group audits and inventories, and Section III addresses other common findings.

Section I – Five findings that require particular attention

1. Quality control policies and procedures

Although HKSQC 1 has been effective for more than eight years, many initial practice reviews still reveal Practices that do not have quality control policies and procedures to address the requirements of HKSQC 1(Clarified). We also found Practices that introduced quality control policies and procedures for the first time just prior to the practice review.

Some Practices that have adopted the Institute's "A Guide to Quality Control" as their quality control manual were not able to explain how the quality control policies and procedures were applied. Others had not tailored the quality control policies and procedures to suit their own circumstances. There were also examples of inconsistencies between policies and procedures set out in a Practice's quality control manual and those actually applied in practice.

Quality control policies and procedures lay the foundation of a quality control system and therefore are fundamental to quality control of a Practice. Policies and procedures adopted need to be appropriate to the size and operating characteristics of the Practice while addressing the principles of HKSQC1 and must be put into practice.

2. Monitoring function

Monitoring is required to be carried out regardless of the size or nature of a Practice's client base. Initial practice reviews of small Practices still frequently reveal that they have not carried out any monitoring. The most common explanation given is that Practices cannot find a suitable and competent external monitor to carry out a review. In previous reports, we have emphasized the importance of monitoring and suggested possible ways to assist Practices in meeting their responsibilities about monitoring. Monitoring responsibility should be entrusted to an individual, internally or externally, with sufficient and appropriate experience and authority to assume that role.

In some cases, although a monitoring review had been carried out, we had doubts about its effectiveness, for instance:

- when there was no documentation to evidence the monitoring review;
- where the review was performed by an individual without appropriate technical expertise or authority;
- where engagement reviews covered only simple or dormant engagements;
- where there was no follow up action taken to address findings identified by the monitoring review;
- where the monitoring review had no or few findings but our review of the same engagements identified a number of findings; and
- where the frequency of the monitoring review does not match the requirement of HKSQC 1 (i.e. annually for review of the quality control system and a cycle of no more than 3 years for engagement reviews)

Monitoring is an important element of quality control and it is important for a Practice to ensure that its monitoring procedures are carried out in a timely and effective manner. We expect that the latest monitoring report, prepared according to the timeframe required by HKSQC1, will be available for our assessment at the time of a practice review.

3. Audit methodology

Many small Practices adopted the Institute's Audit Practice Manual ("APM") as their audit manual but some used only a few of the APM audit programmes particularly for planning and completion. As a result, a number of requirements of auditing standards were not fully and adequately addressed. Common deficiencies included the omission of all or some of the following:

- Audit plan and audit strategy (HKSA 300 (Clarified))
- Understanding of client's business, including key controls and evaluation of design and implementation of controls (HKSA 315 (Clarified))
- Audit risk assessment (HKSA 315 (Clarified)) and response to assessed risks (HKSA 330 (Clarified))

- Fraud risk assessment (HKSA 240 (Clarified))
- Calculation and application of audit materiality, including performance materiality (HKSA 320 (Clarified))
- Preliminary analytical reviews to identify risk areas (HKSA 315 (Clarified)) and final analytical procedures to review and conclude on consistencies between financial statements and auditors' understanding (HKSA 520 (Clarified))
- Consideration of laws and regulations (HKSA 250 (Clarified))
- Subsequent event review (HKSA 560 (Clarified))
- Consideration of going concern assumption (HKSA 570 (Clarified))

Practices should not represent compliance with auditing standards in their audit reports unless they have complied with the requirements of all auditing standards relevant to that audit. Departure from a relevant requirement in an auditing standard is allowed only in exceptional circumstances and alternative audit procedures should be performed to achieve the aim of that requirement. Failure to carry out adequate audit procedures to satisfy the requirements of relevant auditing standards would mean that the Practice could not claim compliance with auditing standards in the audit report. Accordingly, Practices should ensure audits comply with the requirements of all relevant auditing standards and provide appropriate training to staff to ensure they have adequate knowledge about application of the standards.

4. Subcontracting arrangements

As mentioned in previous reports and forums, there are no problems with subcontracting arrangements as a mechanism to engage staff resources, as long as the Practice exercises appropriate control over the subcontractors' work.

However, we still find unsatisfactory subcontracting arrangements that result in poor quality audit work. Common problems, particularly when audit clients were introduced to Practices by subcontractors, include:

- No acceptance or continuance procedures for engagements introduced by subcontractors. Subcontractors sometimes started audit work without informing the Practice and/or were responsible for audit clients' billing and issued fee notes directly to the clients. Such circumstances indicated that the Practice did not have direct contact with its clients.
- Subcontractors did not follow the Practice's quality control policies and procedures or audit methodology and/or carried out most or all of the audit work before approaching the Practice to request its involvement such that the Practice did not have timely involvement in or control over the audit engagement.
- The Practices were not aware of or ignored the fact that their subcontractors provided non-assurance services to clients, as well as being involved in audit work, which posed independence and self review threats.

- Audit files were retained by subcontractors and were not readily accessible by Practices, or some important audit evidence was kept by subcontractors and not on audit files.
- The Practice did not appear to have sufficient resources to properly supervise the large number of subcontracted audit engagements, especially where a sole practitioner has also a full time employment.

Practices have ultimate responsibility for all audits, including subcontracted engagements. If a Practice cannot properly control or supervise a subcontracted engagement then the arrangement is not acceptable. The use of a subcontractor is not a defense when the audit fails.

5. Modified opinion

Practices have a duty to carry out an audit diligently. Diligence encompasses the responsibility to act carefully and thoroughly when carrying out an audit. Practices should use best endeavors to obtain sufficient, relevant and reliable audit evidence to enable them to express an unqualified opinion. The issue of a qualified opinion where practicable audit procedures are available but have not been carried out is not an acceptable approach. However, we continued to identify instances where Practices had misused a modified opinion to circumvent necessary audit procedures. The following are common examples:

- Tax or reporting deadline

  A modified (disclaimer) opinion was issued because the audit team was unable to complete all necessary audit work to support an unqualified opinion before the tax or reporting deadline. There were examples of Practices disclaiming all significant balances in the financial statements because of time constraints.

- Non attendance at stock take

  Modified opinions are issued year after year due to non-attendance at inventory counts, often because the client has not "invited" the auditor to attend. No steps had been taken to resolve the circumstances that gave rise to the limitation of scope. This begs a question whether there was really a limitation or whether it was simply an arrangement of convenience for client and auditor.

Lack of time is not an acceptable reason to issue a modified audit opinion. Practices should assess resource requirements, time contraints and access to information before confirming any engagement acceptance or continuance decision.

Where there is a scope limitation imposed by a client, a Practice should consider alternative audit procedures and should issue a modified opinion only when there are no alternative procedures or where such alternative procedures fail. In addition to qualifying the opinion, the Practice should consider whether the limitation infringes on its statutory duties as auditor and, if it does, the Practice would not normally accept appointment or reappointment.

Section II – Topical issues

6. Group audits

In 2013, we issued an audit alert which summarized common findings on the application of HKSA 600 (Clarified) in the following areas:

- Restrictions on involvement of group auditors in the work of component auditors;
- Group auditors' lack of understanding of component auditors and failure to evaluate their work; and
- Group audit planning, communication with component auditors and documentation.

Common findings on the above areas continued to be identified. HKSA 600 (Clarified) sets out specific requirements for the conduct of group audits, including a requirement for greater involvement by group auditors in the audits of significant components and specified procedures for some circumstances. The requirement for greater involvement in significant components entails the need for group auditors to evaluate the significance of components and consider the extent to which they need to be involved in component audits, in particular on risk assessment and development of risk responses. The extent of involvement will depend on group auditors' assessment of component auditors' independence and competence.

If group auditors are not able to be involved to the extent necessary to satisfy themselves with the work of component auditors, they should plan to carry out audit work directly. Merely receiving documents (e.g. audit questionnaires and clearance) from component auditors after completion of audits without adequate involvement by the group auditors would not satisfy the requirements of HKSA 600. Group auditors should also carefully evaluate reports received from component auditors and determine whether further work is required to satisfy themselves that sufficient appropriate audit evidence has been obtained to support their audit opinion.

Documentation demonstrating adequate involvement of group auditors in the work of component auditors and communication with component auditors is often not prepared by small practices that carry out group audits.

7. Audit of inventories

Inventories can have different characteristics and different costing systems might require specific audit procedures. Therefore the use of standard audit procedures may not always achieve the planned audit objectives. The following are common deficiencies identified in audit of inventories:

- Physical inventory counts
  - ➢ Practices did not attend physical inventory counts but provided no reasons why such arrangements were impracticable. Physical inventory counting not only enables auditors to ascertain the existence of inventory but also to identify obsolete, damaged or aging inventory. Therefore, cost constraints, insufficient manpower or general inconvenience due to location and time is not a valid reason for omitting this important audit procedure.

- When physical inventory counting was carried out at a date other than the year end date, Practices failed to perform audit procedures to test transactions during the intervening period to ensure the movements were properly recorded.
- Where inventory under the custody and control of a third party was material to the financial statements, Practices only obtained confirmation from the third party as to the quantities of inventories held on behalf of the client without consideration of the need to inspect or perform other audit procedures to ascertain the existence or condition of the inventory.
- Practices attended the physical inventory counts but did not check whether the count results agreed with the client's final inventory records.

- Trading inventories
  - Unit price tests on inventory items were limited to checking the latest supplier invoice without considering whether the costing method was properly applied. Practices need to understand the costing method, e.g. first-in-first-out or weighted average, adopted by clients and design appropriate audit procedures to test whether costs of inventories are properly determined.
  - Practices failed to consider whether the retail method of inventory measurement was appropriate for their clients, in particular if they are not in the retail industry, and did not perform adequate audit work to ensure that the results of inventory measurement using the retail method approximates to the cost of inventories.
  - No follow up procedures on inventory items without subsequent sales (e.g. understand the reasons and check last selling prices) to ensure inventories were not stated at above net realizable values.
  - Insufficient or no audit procedures to assess the appropriateness of or need for inventory provision. Practices should 1) understand clients' policies for determining inventory provision; 2) evaluate whether the policies are appropriate and reasonable; 3) review clients' calculations; and 4) obtain evidence to verify whether the information used by clients in their calculations is appropriate and reasonable. Reference should be made to the aging analysis of inventory and the condition of inventories noted during the physical stock inventory counts.

- Manufacturing inventories
  - Financial impact of not absorbing costs of conversion of inventories (direct labor and production overheads) into costs of work-in-progress ("WIP") and finished goods ("FG") was not considered. Practices should request their clients to quantify the effect and perform audit procedures to ensure that the client's quantification is reasonable. If the effect is material, Practices should request their clients to make appropriate adjustments to their financial statements.

- Practices did not check bill of materials for WIP and FG to ensure cost records for those categories of inventory were accurately updated to reflect latest cost information. Practices did not assess clients' approach for determining costs of WIP and design specific procedures to assess the reasonableness of the costing approach.

Inventories are often a major item in financial statements. Practices should ensure that they carry out sufficient appropriate work on this important area of an audit.

Section III – other common findings

8. Audits of listed companies

In this third cycle of reviews, there have been signs of improvement in the quality of listed company audits. However, there are still a number of areas which require continued attention:

Engagement quality control (EQC) reviews

There was often limited evidence to show that the EQC reviewer had adequate involvement in the audit, for example:

- Other than signing the EQC review checklist, there was no other documentation on file to evidence the extent of work undertaken by the EQC reviewer, particularly on key judgement and risk areas;
- Engagement time records showed that little time was spent by the EQC reviewer; and
- The EQC review was completed after the audit report date.

An EQC review is a critical element of control over audit quality. To ensure this quality control function is effective, it is important that the EQC reviewer is involved at the right time and to the extent necessary throughout the audit process and their evaluation of critical audit areas and key judgement made during the audit is sufficiently evidenced.

Fee dependence

Fee dependence is a common issue for smaller Practices with one or two large listed clients. However, some Practices had not addressed the Code of Ethics requirement to implement additional safeguards if fee income from a listed client exceeds 15% of total fees of the Practice for two consecutive years. If such circumstances arise, the Practice should disclose this fact to those charged with governance of the listed client and apply safeguards, such as external pre-issuance review and/or post-issuance review of the audit engagement, to reduce the threat to an acceptable level. If no appropriate safeguards can be put into place, the Practice should consider not accepting or resigning from the engagement.

9. Client and engagement acceptance and continuance

Common issues identified in relation to client and engagement acceptance and continuance were as follows:

- Replies to professional clearance request letters were received after engagements were accepted and/or engagement letters were sent;
- The implications of disclaimer opinions issued by predecessor auditors because of limitations of scope imposed by management were not considered;

- No action was taken to resolve matters giving rise to modified opinions issued for the prior period; and
- Engagement letters were outdated and not revised to address the requirements of HKSA 210 (Clarified).

Before accepting or continuing with an engagement, as well as considering the integrity of the client, Practices should assess whether they have the necessary skills and experience to perform the engagement and are able to comply with relevant ethical requirements. Professional clearance should be obtained before accepting an engagement so that Practices are aware of any unusual circumstances surrounding the engagement which may affect the acceptance decision. Should Practices foresee that management will impose a limitation on the scope of their work such that they believe the limitation will result in them disclaiming an opinion on the financial statements, they should not accept the audit engagement.

For recurring audit engagements, Practices should also assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the client of existing terms of the engagement.

10. Provision of non-assurance services to audit clients

Many Practices did not go through the "threats and safeguards" evaluation process when non-assurance services, in particular bookkeeping and accounting, were provided to their audit clients by them or their affiliates, subcontractors or staff.

Although Practices are not prohibited by the Code of Ethics from providing such services to small private company audit clients, they are required to evaluate the significance of threats in order to determine whether and, if so, what safeguards need to be applied. Practices should also document this process.

The Institute has recently revised Ethics Circular 1 (Revised) *Guidance for Small and Medium Practitioners on the Code of Ethics for Professional Accountants* which addresses this matter.

11. Audit of revenue

In HKSA 240 (Clarified), there is a rebuttable presumption of fraud risk in revenue recognition. Some practices did not understand HKSA 240 (Clarified) and did not either treat revenue as a significant risk area or provide justification for rebutting the presumption. Unless the presumption is rebutted, Practices should evaluate which types of revenue transactions or assertions give rise to such risk, obtain an understanding of the client's relevant controls and design appropriate audit procedures to address the risk.

In some cases where revenue was generated from sales of goods or provision of services, Practices only checked internally generated sales invoices or service billings as transaction and cut-off tests. Clients' accounting policies for revenue should be reviewed to determine when revenue should be recognized and, based on the assessment and understanding of the clients' financial reporting system, documents with third party evidence to support the recognition of revenue, e.g., goods delivery documents with acknowledgement of goods received by customers, should be inspected.

12. Asset impairment

Given the complexity of an asset impairment assessment, many Practices obtain audit evidence to corroborate rather than challenge clients' judgment. Common issues on audit of asset impairment are as follows:

- Projected growth rates set by client appeared unrealistically high compared to client's historical performance but there was no evidence on file that they were critically questioned by the Practice;
- Discount rate applied by client appeared unreasonably low but the Practice did not critically evaluate whether the rate reflected current market conditions as well as the risks specific to the client's asset ;
- Projected cash flows prepared by client were not in compliance with HKAS 36 e.g. the cash flow forecasts included tax payments, costs and benefits of a future expenditure that is intended to improve or enhance the assets or business, but the Practice did not address or evaluate the impact of non-compliance; and
- Goodwill was wrongly allocated to cash generating units which were larger than an operating segment but the Practice did not evaluate the impact of non-compliance with HKAS 36.

Practices often explained that they tried their best and used all information available to audit asset impairment under a tight reporting timeframe. While goodwill and intangibles with indefinite useful lives are required to be tested for impairment at least annually, the test can be performed any time in the financial year, not necessarily at the year end, provided it is performed at the same time each year. When Practices believe that they are not able to carry out a proper impairment assessment of those assets before the reporting timeframe, they should liaise with their client, carry out the test earlier in the year and only update the test at the year-end if there is an indication that the assets might be impaired.

In general, Practices should heighten the level of professional skepticism when assessing evidence of asset impairment that involves significant estimation or judgment by clients. Persuasive audit evidence should be obtained on these areas. Practices should ensure there is sufficient audit evidence on file to reduce the risk of being challenged by external reviewers or regulators in relation to their audit procedures performed or conclusions reached. Engagement teams should have a full understanding of the accounting requirements of HKAS 36.

13. Audit documentation

Many of the issues raised in our reviews related to audit documentation in that Practices did not document work performed on significant audit areas. For instance, audit work papers did not state sample selection basis, how tests were performed, results of audit procedures and audit team's assessment on key judgment areas.

All audit procedures should be properly documented. Practices should remind their partners and staff of the importance of good quality audit documentation that should enable an experienced auditor, having no previous connection with the audit, to understand:

- The nature, timing, and extent of the audit procedures performed;
- The results of the audit procedures performed and evidence obtained; and
- Significant matters arising during the audit, the conclusions reached thereon and significant professional judgments made in reaching those conclusions.

Oral explanations by Practices, on their own, do not provide adequate support for the work performed or conclusions reached, although they may be used to explain or clarify information contained in the audit documentation. When there is no documentation to evidence the audit work, it is hard to accept that the Practice had performed adequate work to reach a conclusion and complied with relevant professional standards.

Our findings

Professional standards monitoring programme

Based on our 2013 reviews of financial statements of Hong Kong listed companies, we have identified and summarized the more significant or common accounting issues and disclosure deficiencies. Some of the issues and deficiencies have been identified in previous years. This indicates that even Standards that have been effective for some time are not well understood. Therefore, we hope that this publication will help members better apply the Standards in preparing financial statements.

There were no new major issues identified during our reviews in 2013. There were only a few new and revised Standards that became effective for the financial statements subject to our reviews and their impact was minimal.

A number of investment Standards that are expected to have more significant impacts on financial statements have already become effective in 2013. For example, HKFRS 10 *Consolidated Financial Statements*, which introduced a single control model and a new definition of "control" as compared to the previous HKAS 27 (Revised) *Consolidated and Separate Financial Statements* and the superseded HK (SIC) – Int 12 *Consolidation – Special Purpose Entities*, might require some entities to change their consolidation conclusions. We shall monitor how the listed companies apply these new investment Standards in our future reviews.

Staff summaries are available in the Institute's website to provide a broad overview of new and revised Standards effective from 2013:

http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/staff-summary/

Section I – Common or significant accounting issues

1. HKAS 39 *Financial Instruments: Recognition and Measurement*

   HKAS 39 is still one of the more challenging Standards. Although it will be ultimately replaced by HKFRS 9 *Financial Instruments* in its entirety, compliance with HKAS 39 remains necessary until HKFRS 9 becomes effective. In this year's report we share three accounting areas under HKAS 39 which we believe are not well understood and give rise to many questions on application.

   a. Accounting for discounted bills

      A reporting entity had financing arrangement whereby it discounted bill receivables to certain banks. In the consolidated financial statements, the reporting entity derecognized (i.e. removed) the receivables related to the discounted bills and disclosed funds received from the banks as contingent liabilities. There was no other information such as the terms and conditions of and the accounting policy for the discounted bills disclosed elsewhere in the financial statements to explain how the relevant receivables were qualified for derecognition.

In response to our enquiries, the auditor advised that the banks had a legal right of recourse regarding the discounted bills, i.e. the reporting entity was responsible for repayments if the bills were defaulted at the maturity date. This indicated that not substantially all the risks and rewards of ownership of the discounted bills had been transferred from the reporting entity to the banks. Therefore, although the legal right to receive cash from those receivables was transferred to the banks, the reporting entity should not derecognize the receivables.

Under HKAS 39, a financial asset is derecognized when (a) an entity has transferred a financial asset and (b) the transfer qualifies for derecognition. The evaluation of the transfer of "risks and rewards" and "control" are two important concepts under HKAS 39 which govern whether and when a financial asset should be derecognized. It should however be noted that the Standard requires an evaluation of the transfer of risks and rewards of ownership to precede an evaluation of the transfer of control for derecognition assessment (HKAS 39 paragraph 20, Introductory paragraph IN9 and BC48). HKAS 39 paragraph AG36 provides a decision tree that explains the flow of the application of derecognition tests. As shown in the decision tree, the "risks and rewards" test should be applied first and the "control" test should be applied only when the entity has neither transferred nor substantially retained all risks and rewards of ownership of the financial asset (HKAS 39 paragraph 20(c)). However, if the entity has transferred substantially all risks and rewards of the ownership of the financial asset, it should derecognize the asset without the need to further consider whether or not it has retained control of the asset.

Regarding evaluation of the transfer of risks and rewards of ownership, HKAS 39 paragraph 29 states that "*If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability*". The entity should consider, whether having transferred a financial asset, it will continue to be exposed to the risks of ownership of that asset or continue to enjoy the benefits generated by the asset.

In respect of discounted bills, the assessment of whether the transfer of receivables qualifies for derecognition should be based on all facts and circumstances including the terms and conditions of the financing arrangements, the credit quality of the bill issuers, the risk of fair value change of the discounted bills as a result of interest rate movement and the risk of non-settlements by the bill issuers at the maturity date. If they are not qualified for derecognition, then the reporting entity should follow HKAS 39 paragraph 29 to account for the

transactions. Careful consideration is needed to avoid inappropriate accounting treatment in the financial statements.

HKAS 39 also provides examples of when an entity has transferred substantially all of the risks and rewards of ownership. However, apart from that, there is no clear guidance provided in HKAS 39 on how to determine whether risks and rewards have been "substantially" transferred and therefore judgement will need to be applied. Accordingly, the critical judgments exercised by management in applying the accounting policy for discounted bills should be disclosed.

In addition, the Amendments to HKFRS 7 *Disclosures – Transfers of Financial Assets*, effective for annual periods beginning on or after 1 July 2011, increased the disclosure requirements for transactions involving a transfer of financial assets to provide more transparency of the risk exposures. The disclosure requirements cover both transfers of financial assets that are not derecognized and those transfers where the financial assets are derecognized but the reporting entity has a continuing involvement in those assets.

b. Impairment assessment of available-for-sale equity investments

Some reporting entities accounted for their unlisted available-for-sale equity investments at cost less impairment, instead of fair value with the fair value changes recognized in other comprehensive income. Due to the lack of information provided in some financial statements, we are concerned that a thorough consideration based on the requirements of HKAS 39 before reaching the conclusion to account for those investments at cost less impairment has not always been undertaken.

In one set of financial statements the available-for-sale equity investment was recognized at cost less impairment. However, the reporting entity also disclosed the fair value of the same investment in the financial statements which suggested that the fair value of the investment could be measured and raised doubts as to why the investment was not recognized at fair value under HKAS 39.

There is no accounting policy choice (i.e. at "fair value" or at "cost less impairment") provided in HKAS 39 for available-for-sale equity investments. HKAS 39 paragraph 46 states that "*After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets: ….. (c) investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost*" (underline added). Therefore unquoted

available-for-sale equity investments shall be measured at fair value unless they fall within the exception provided in HKAS 39 paragraph 46(c).

HKAS 39 paragraphs AG80 and AG81 provide further guidance on this matter. In considering whether the fair value of an unlisted investment that does not have a quoted market price in an active market can be reliably measured or not, HKAS 39 paragraph AG80 provides that the entity would consider two factors: (a) the significance of the variability in the range of reasonable fair value estimates; and (b) whether the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

HKAS 39 paragraph AG81 further states that "*There are many situations in which the variability in the range of reasonable fair value estimates of investments in equity instruments that do not have a quoted market price and derivatives that are linked to and must be settled by delivery of such an unquoted equity instrument….. is likely not to be significant. Normally it is possible to estimate the fair value of a financial asset that an entity has acquired from an outside party*" (underline added).

Based on the above provisions, an available-for-sale equity investment can be stated at "cost less impairment" only if there is a "significant range" of possible fair value estimates and the "probabilities" of the various estimates cannot be "reasonably assessed". The relevant provisions in HKAS 39 must be carefully considered before applying or concurring with the "cost less impairment" treatment.

If the relevant requirements of HKAS 39 are fulfilled and the unquoted equity investments are carried at cost less impairment, the information required by HKFRS 7 *Financial Instruments: Disclosures* paragraph 30 must be properly disclosed in the financial statements. In some financial statements, those disclosures were missing.

c. Accounting for financial guarantee contracts

The amendments to HKAS 39 and HKFRS 4 *Insurance Contracts* regarding accounting for financial guarantee contracts by issuers of the contracts have been effective since 2006. However some entities still inappropriately regarded financial guarantee contracts issued as "contingent liabilities" and therefore did not recognize them in the financial statements. As HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* does not apply to financial guarantee contracts that are within the scope of HKAS 39 (HKAS 37 paragraph 2), it is not appropriate to regard the financial guarantee contracts as contingent liabilities. The accounting treatment is further explained below:

HKAS 39 defines a financial guarantee contract as "*a contract that requires the*

issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument". A typical example of a financial guarantee is where a parent company (the "issuer") provides a financial guarantee to a third party bank (the "holder") in respect of loans or banking facilities granted by the bank to a subsidiary.

If an issuer of a financial guarantee contract has previously asserted explicitly that it regards such contract as an insurance contract and has used accounting applicable to insurance contracts, the issuer may elect to apply either HKAS 39 or HKFRS 4 to account for the financial guarantee contract. Under HKAS 39, the issuer initially recognize such contract at fair value and subsequently measure it at the higher of (a) the amount determined in accordance with HKAS 37 (i.e. the best estimate of the expenditure required to settle the present obligation at the end of the reporting period); and (b) the amount initially recognized less, when appropriate, cumulative amortisation recognized in accordance with HKAS 18 *Revenue*.

In response to a query we were advised that the reporting entity had been applying HKFRS 4 for financial guarantee contracts issued. However, the reporting entity did not disclose an accounting policy or make the explicit assertion as required by HKFRS 4.

Financial guarantee contracts issued must also be included in the maturity analysis for financial liabilities as required by HKFRS 7 paragraph 39(a). This disclosure was sometimes omitted.

2. Reverse acquisitions under HKFRS 3 (Revised) *Business Combinations*

When consideration for a business combination is satisfied by equity instruments, the legal acquirer that issues the equity instruments might not necessarily be the "acquirer" under HKFRS 3 (Revised) for accounting purposes. This occurs when there is a reverse acquisition. The related issues that we have identified are further discussed below:

In reviewing business combination transactions, there were occasionally significant changes in the acquiree subsequent to the acquisition (see below for examples) which indicated that "a reverse acquisition" as envisaged under HKFRS 3 (Revised) might have taken place: i.e. in substance the legal acquirer or legal parent, commonly an existing listed company, should be the "accounting acquiree" whereas the legal acquiree or legal subsidiary should be the "accounting acquirer". For these transactions, the consideration was satisfied commonly by the issue of convertible instruments by the legal acquirer to the original parent of the legal subsidiary.

Common changes following acquisitions were:

- A change in the name of the listed company (i.e. the legal parent) to a name similar to the name of the legal subsidiary.
- The original parent of the legal subsidiary, upon full conversion of the convertible instruments at the maturity date, would have the majority interest of the enlarged share capital of the listed company. In other words, it would be able to obtain the majority of voting rights of the listed company through conversion of the convertible instruments.
- New personnel, who were from the legal subsidiary or the original parent of the legal subsidiary, were appointed as directors, chief executive officer or chairman of the listed company. These changes in the composition of the board of directors and senior management indicated that the listed company may have come under control of the legal subsidiary (legal acquiree) as a result of the acquisition.
- There was a change of the address of the head office and principal place of business of the listed company to the subsidiary's location.

Such transactions were often treated as acquisitions rather than reverse acquisitions. As there was insufficient information provided in the financial statements, it was unclear whether adequate consideration had been given to the requirements of HKFRS 3 (Revised) in determining an appropriate accounting treatment for the transaction. The requirements of HKFRS 3 (Revised) on reverse acquisitions are explained below:

For each business combination, one of the combining entities shall be identified as the acquirer. Therefore, in determining whether the transaction is a reverse acquisition or not, the first step is to identify which party in the transaction is the acquirer (i.e. accounting acquirer). As explained in HKFRS 3 (Revised) paragraph B13, the guidance in HKAS 27 (Revised) *Consolidated and Separate Financial Statements* (HKFRS 10 effective from 2013) shall be used in identifying the acquirer – the entity that obtains control of the acquiree. If a business combination has occurred but applying the guidance in HKAS 27 (Revised) (HKFRS 10 effective from 2013) does not clearly indicate which of the combining entities is the acquirer, the factors in HKFRS 3 (Revised) paragraphs B14 to B18 shall be considered in making that determination.

Examples of pertinent facts and circumstances that are provided in HKFRS 3 (Revised) paragraph B15 for consideration are:

- The relative voting rights in the combined entity after the business combination;
- The existence of a large minority voting interest in the combined entity if no other owner or organized group of owners has a significant voting interest;
- The composition of the governing body of the combined entity;
- The composition of the senior management of the combined entity; and
- The terms of the exchange of equity interests

HKFRS 3 (Revised) paragraphs B19 to B27 provide guidance on accounting for a reverse acquisition. As HKFRS 3 (Revised) is only applicable for a business combination where the acquiree is a business, the accounting acquiree (legal parent) must meet the definition of a business before the transaction can be accounted for as a reverse acquisition. Thorough consideration should be given to all pertinent facts and circumstances surrounding the transactions and significant judgement might need to be applied. Management's judgement in applying the accounting policy for the acquisition should be disclosed where appropriate.

3. HKAS 36 *Impairment of assets*

Deficiencies in impairment assessment still rank top in our review observation list. The following highlights some recurring significant accounting issues relating to impairment assessment of investments including associates, jointly controlled entities and subsidiaries. For disclosure deficiencies, please refer to Section II.

a. Determination of recoverable amount

HKAS 36 requires that an asset shall not be carried at an amount higher than its recoverable amount. HKAS 36 defines "recoverable amount" of an asset or cash-generating unit as the higher of its fair value less costs to sell and value in use, which means that the asset must not be carried in the financial statements at more than the highest amount expected to be recovered through use or sale. All references to "fair value less costs to sell" in HKAS 36 have been replaced with "fair value less costs of disposal" for alignment with HKFRS 13 *Fair Value Measurement* which became effective in 2013. Under HKFRS 13, "fair value" is defined as "*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*". "Value in use" is management's best estimate of future cash flows that an asset or cash-generating unit will generate under its current condition, discounted to its present value by using an appropriate pre-tax discount rate.

The requirements of HKAS 36 were not always followed in determining the recoverable amount of an investment. This is further discussed below:

(i) Appropriateness of assumptions used for determining impairment loss and subsequent reversal of impairment loss

One reporting entity provided a significant impairment loss for an interest in a JCE based on a valuation report prepared by an independent professional valuer. In the subsequent year, the reporting entity reversed the accumulated impairment loss provision (including the impairment made in the previous year) based on another valuation report from the same valuer.

We were concerned whether the professional valuations on which the impairment provisions were based had

been carried out in accordance with HKAS 36. In particular, the financial statements disclosed that there were significant changes in the discount rates used between the two years but it was unclear whether they had been determined appropriately under HKAS 36 paragraph 55, which requires consideration of both the time value of money and the risks specific to the asset.

It seemed that the management and/or the auditor might have placed too much reliance on the professional valuations. It is the management and not the professional valuer that takes the ultimate responsibility for the impairment assessment. Therefore management should ensure that the professional valuers have complied with all relevant requirements of HKAS 36 in producing their valuations. Auditors have the responsibility to gain an adequate understanding of the valuations and obtain sufficient audit evidence to support their audit conclusion on the impairment assessment.

(ii) Cash flow projections

In one set of financial statements the recoverable amount of a cash-generating unit (which was a subsidiary of the reporting entity) was derived from its value in use. The value in use was determined by using cash flow projections based on a financial budget approved by the directors covering a "ten-year" period, which was longer than the maximum five-year period in general as provided in HKAS 36. The auditor explained that the subsidiary had obtained a licence from the government to run the business for ten years and therefore it was satisfied that using a ten-year financial budget, which was approved by the directors and supported by the licence, was justifiable. However we consider that, while this supported that the "useful life" of operating the business was ten years under the licence period, it was not sufficient to conclude that the financial budget covering a ten-year period for impairment testing was appropriate.

As stated in HKAS 36 paragraph 35, in measuring value in use, detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. Management may use cash flow projections based on financial budgets over a period longer than five years only if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period. The justification for using financial budgets covering a period of more than five years should also be disclosed. None of the above conditions and disclosure required was present in the above case to support the appropriateness of using the ten-year financial budget.

(iii) Determination of fair value less costs to sell

HKAS 36 paragraph 20 recognizes that sometimes it would not be possible to determine the fair value less costs to sell because there is no basis for making a reliable estimate. However, where a significant impairment loss was recognized for a newly acquired cash-generating unit based on its value in use, we would raise an enquiry to understand (i) whether the fair value less costs to sell valuation of the cash-generating unit had been determined for the impairment assessment; and (ii) the justification why it was not determined given that an estimation of the fair value of the cash-generating unit should have been performed at the time of acquisition.

b. Indicators and timing of impairment testing

If a reporting entity has a listed associate or Jointly Controlled Entity ("JCE"), a fall in the quoted share price of the associate or JCE to below its carrying amount might provide an indicator that the investment might be impaired.

One reporting entity acquired a listed associate and recognized significant goodwill on the acquisition date. At the end of the same reporting period in which the acquisition took place, the market value of the associate dropped significantly below its carrying amount. There was no disclosure to explain how the recoverable amount of the investment was determined and why no impairment provision was required. In response to our enquiry, the auditor explained that the associate had been acquired only a few months earlier and the management was not aware that any material adverse events relating to the investment had occurred after the acquisition. We considered that such explanation was insufficient to support that an impairment assessment was not necessary, as the significant decline of the market value of the associate had provided an indication (HKAS 36 paragraph 12(d)) or objective evidence (HKAS 39 paragraph 61) that the investment might be impaired at the year end.

HKAS 28 *Investments in Associates* paragraph 33 (HKAS 28 (2011) *Investments in Associates and Joint Ventures* paragraph 42 effective from 2013) requires the entire carrying amount, including the related goodwill, of the associate or JCE accounted for using the equity method to be tested for impairment in accordance with HKAS 36 as a "single asset" whenever application of HKAS 39 indicates that the investment may be impaired. Any impairment loss recognized is not allocated to any asset, including goodwill, that forms part of the carrying amount of the investment in the associate.

HKAS 36 requires an annual impairment test of the cash-generating unit or groups of cash-generating units to which goodwill

has been allocated. The impairment test may be performed at any time during an annual period, provided the test is performed at the same time every year. However, HKAS 36 paragraph 96 specifically requires that "*if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period*". That means an impairment test is still required before the end of the current annual period even if the business combination is completed only a short period before the end of that period.

HKAS 36 paragraph 97 also requires that if individual assets comprising the cash-generating unit to which goodwill has been allocated are tested at the same time as the unit containing the goodwill, they shall be tested for impairment "before" the unit containing the goodwill. This sequence of impairment tests will identify and require recognition of an impairment loss on assets before the cash-generating unit containing goodwill is tested for impairment.

c. Investments in subsidiaries at company level financial statements

The consolidated equity of the reporting entity as shown in its consolidated financial statements was sometimes significantly lower than the equity in the reporting entity's company level financial statements. This indicates that the investments in subsidiaries carried at the company level financial statements may have been impaired.

Although investments in subsidiaries are fully eliminated on consolidation, auditors still need to consider whether there are any impairment issues at the company level, in particular when an audit opinion is issued on the separate financial statements.

d. Impairment assessment of goodwill recognized from acquisition of subsidiaries

As with the impairment assessment of interests in associates and JCEs, we also found examples where there was no impairment provided on goodwill recognized from an acquisition of subsidiaries despite poor financial performance of the subsidiaries. This is one of the most common findings from our reviews of the past few years.

HKFRS 3 (Revised) resulted in some amendments to certain paragraphs in, and added a new Appendix C, to HKAS 36. HKAS 36 paragraphs C3 and C4 set out the requirements for goodwill attributable to non-wholly owned subsidiaries. Under the requirements, if an entity measures non-controlling interests as its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, the entity shall "gross up" the carrying amount of goodwill allocated to the cash-generating unit to include the goodwill attributable to the non-controlling interest

and compare the adjusted carrying amount of the unit with the recoverable amount of the unit to determine whether the unit is impaired or not.

4. HKAS 1 (Revised) *Presentation of Financial Statements*

   As required by HKAS 1 (Revised) paragraph 15, financial statements should give a true and fair view of the financial position, financial performance and cash flows of an entity. A true and fair view requires the faithful representation of the effects of transactions, events and conditions in accordance with the *Framework*. HKAS 1 (Revised) paragraph 17 also states that a true and fair view requires an entity to present information in a manner that provides relevant, comparable and understandable information and provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the financial impact of transactions.

   Some financial statements contained insufficient disclosures to enable a reader to understand the nature and related financial impact of particular events or transactions. For instance, in one set of financial statements, there was a significant other payable waived during the year resulting in a significant gain recognized but there was no disclosure to explain the reasons supporting the treatment. In addition, certain subsidiaries were reclassified as jointly controlled entities during the year but there were no disclosures to explain the accounting treatment and related financial impact. In one example, we considered that the disclosures on a number of areas were so grossly insufficient, that there were questions whether the financial statements provided a "true and fair view", as required by HKAS 1 (Revised). More discussions on disclosure deficiencies are set out in Section II below.

Section II – Common disclosure deficiencies

Our 2013 reviews identified similar disclosure deficiencies which have been discussed in previous years' reports. This pattern of findings suggests there may be a perception that as long as the accounting treatments are appropriate, disclosure deficiencies are less important. Sufficient and clear disclosures are important to ensure that the financial statements provide a true and fair view.

For more understanding of missing disclosures in relation to the application 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*, that have been discussed in our 2012 QAD annual report, please use the following link.

http://www.hkicpa.org.hk/file/media/section6_standards/quality_assurance/2013/qa-annual-report-2012.pdf

There also continue to be common disclosure deficiencies in respect of other Standards.

1. HKFRS 3 (Revised) *Business combinations*

   The following disclosures were often omitted or incomplete:

   - the amount of acquisition-related costs and the amount of those costs recognized as an expense and the line item(s) in the consolidated statement of comprehensive income in which those expenses were recognized;
   - the composition of the consideration paid;
   - a qualitative description of the factors that make up the goodwill recognized;
   - the measurement basis of recognition of non-controlling interest in the acquisition, i.e. at fair value or proportionate share of the fair value of acquiree's identifiable net assets;
   - the information about acquired receivables at the acquisition date, including the fair value, and the gross contractual amounts, of the receivables and the best estimate at the acquisition date of the contractual cash flows not expected to be collected;
   - the amounts of revenue and profit or loss of the acquired subsidiary since the acquisition date included in the consolidated statement of comprehensive income for the reporting period;
   - the revenue and profit or loss of the combined entity for the current reporting period as if the acquisition date had been as of the beginning of the reporting period; and
   - the information required by HKFRS 3 (Revised) paragraphs B64 and B66 in relation to business combinations completed after the end of the reporting period but before the financial statements are authorized for issue.

   The accounting policy for non-controlling interests disclosed in many financial statements stated that, for each business combination, the entity can elect to measure any non-controlling interests either at fair value or at its proportionate share of the acquiree's net identifiable assets. However, the amendments to HKFRS 3 issued in May 2010 have clarified that the choice of measuring non-controlling interests is limited to those components of non-controlling interests that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. All other components of non-controlling interests shall be measured at their acquisition-date fair values, unless another measurement basis is required by HKFRSs. For this reason, when entities prepare their accounting policy for non-controlling interests, they should make it clear that the free measurement choice is only applicable to non-controlling interests that represent ownership interest.

2. HKFRS 7 *Financial Instruments: Disclosures*

The following disclosures were omitted or incomplete:

- disclosures required by HKFRS 7 paragraph B5(a) for financial assets or liabilities designated at fair value through profit or loss;
- disclosures required by HKFRS 7 paragraph 27B(c) regarding fair value measurement in Level 3 of the fair value hierarchy;
- carrying amount of financial instruments by categories which are specified under HKFRS 7 paragraph 8;
- a reconciliation of changes in allowance for credit losses during the reporting period for each class of financial assets;
- an analysis of the age of financial assets that are past due at the year end but not impaired;
- an analysis of financial assets that are individually determined to be impaired at the year end, including the factors considered in determining that they are impaired;
- information about the credit quality of financial assets that are neither past due nor impaired;
- information about concentration of credit risk, for example when the reporting entity has only a few major customers or the location of customers concentrated in certain geographical areas;
- the methods and, when a valuation technique is used, the assumptions applied in determining fair values of financial instruments, e.g. embedded derivatives;
- credit risk disclosures required by HKFRS 7 for financial assets such as retention receivables and other receivables. Some reporting entities disclosed credit risk information for trade receivables only;
- a sensitivity analysis of each type of market risk to which the reporting entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
- a separate maturity analysis of derivative financial liabilities. As required by HKFRS 7 paragraph 39(b), the maturity analysis of derivative financial liabilities of the reporting entity shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows; and
- all HKFRS 7 disclosures relevant to the company level when an audit opinion is given on the statement of financial position of the reporting entity.

Regarding the disclosure of a maturity analysis for financial liabilities, HKFRS 7 paragraph B11C(a) states that "*when a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay.*" (underline added). For example, if the reporting entity will be required to redeem a five-year convertible bond after two years from the end of the reporting period when the bondholder requests the redemption, then the relevant undiscounted cash flows in the maturity analysis should be presented under the time band such as "later than two years and not more than three years". Some maturity analyses were only based on the maturity dates of the financial liabilities without taking into account the requirement of HKFRS 7 paragraph B11C(a).

Currency risk disclosures sometimes included financial instruments of subsidiaries but such financial instruments were denominated in the "functional currency" of those subsidiaries. As stated in HKFRS 7 paragraph B23, currency risk does not arise from financial instruments denominated in the functional currency of an entity. Therefore currency risk disclosures for a group should not include financial instruments of the subsidiaries which were denominated in the functional currencies of those subsidiaries.

As a result of the issue of HKFRS 13 (effective from 2013), fair value disclosures such as disclosures of fair value hierarchy have been removed from HKFRS 7 and included in HKFRS 13 with some amendments.

3. HKFRS 8 *Operating Segments*

   The following disclosures were omitted or incomplete:

   - disclosures of items required by HKFRS 8 paragraph 23 in respect of each reportable segment (e.g. depreciation and amortisation, income tax expense or income) if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker ("CODM"); or are otherwise regularly provided to the CODM; even if not included in the measure of the segment profit or loss;
   - reconciliations as required by HKFRS 8 paragraph 28 between the segment information and the reporting entity's financial information; and
   - entity-wide disclosures including information about the reporting entity's products and services, major customers and geographical areas, e.g. revenues from external customers for each product and service; if revenues from transactions with a single external customer amount to 10 per cent or more of an entity's revenues, the amount of revenues from each such customer, and the identity of the segment(s) reporting the revenues; and non-current assets other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (i) located in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets.

     Entity-wide disclosures are applicable even when the reporting entity only has one single reportable segment.

4. HKAS 36 *Impairment of Assets*

   The following disclosures were omitted or incomplete:

   - events and circumstances that led to recognition or reversal of impairment losses;
   - discount rate(s) used in the current and previous estimates if the recoverable amount is based on value in use;
   - growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts; and
   - explanation of why management has projected cash flows based on a financial budget covering a period more than five years.

   HKAS 36 paragraph 130 was amended in June 2013 regarding the disclosures of the recoverable amount of impaired assets that is based on fair value less costs of disposal. The amendments are to be applied retrospectively for annual periods beginning on or after 1 January 2014. Earlier application is permitted for periods when the entity has already applied HKFRS 13.

Communication 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. More common and significant matters found in the review programmes were communicated to members through different channels:

- The QAD hosted two forums, in June and September 2013, that attracted a combined audience of approximately 530. The forums addressed common myths about and findings from practice reviews and covered audit of insurance brokers as a special topic. A webcast of the forum is available at the Institute's website for subscription until 15 February 2015.

- In November 2013, the QAD organized a joint forum with the FRC and HKEx which drew approximately 310 attendees. Common issues identified by the reviews of financial statements of Hong Kong listed companies carried out by the three bodies were presented. A webcast of the forum is available at the Institute's website for view until 15 March 2015.

- The Director of the QAD covered common practice review findings on group audits in the 2013 Annual Auditing Update Conference held on 26 October 2013.

- The Director of the QAD and representatives of the PRC attended the SMP Symposium held on 29 November 2013 to discuss common practice review findings and recommendations.

- Two Financial and Auditing Alerts, No. 17 on audits of group financial statements and No. 18 on documentation requirements for group auditors and practical implications for auditor regulation for Hong Kong, were sent to practising members in 2013.

Findings from the reviews have also been used by the Institute's technical team to provide relevant support for members through regular technical training sessions.

Members of the Standards & Quality Accountability Board in 2013

Name	Position	Company
Mr. BEST, Roger Thomas	Chairman	
Ms. CHUNG, Lai Ling, Ada (Appointed 22 January 2013)	Member	Companies Registry, HKSAR
Mr. GRIEVE, Charles Ramsay	Member	Securities & Futures Commission
Mr. KENNEDY, Paul	Member	Hong Kong Exchanges and Clearing Limited
Mr. SIU, Man Tat, Martin (Appointed 19 February 2013)	Member	The Treasury, HKSAR
Mr. TONG, Eric (Appointed 22 January 2013)	Member	Deloitte Touche Tohmatsu
Mr. WONG, Tat-cheong, Frederick	Member	Audit Commission, HKSAR

Members of the Practice Review Committee in 2013

Name	Position	Company
Miss CHAN, Mei Bo, Mabel	Chairman	Mabel Chan & Co.
Mr. FUNG, Hon Kwong, Tommy	Deputy Chairman	Ernst & Young
Mr. GEORGE, Richard John Weir	Member	Deloitte Touche Tohmatsu
Mr. CHAN, Shu Kin, Albert (Appointed 22 January 2013)	Member	Ting Ho Kwan & Chan
Miss CHAN, Wai Ching (Appointed 22 January 2013)	Member	PricewaterhouseCoopers
Mr. FAN, Chun Wah, Andrew	Member	C.W. Fan & Co.
Mr. HON, Koon Fai, Alex	Member	HLB Hodgson Impey Cheng Limited
Mr. LIU, Eugene (Appointed 22 January 2013)	Member	RSM Nelson Wheeler
Mr. NG, Kar Ling, Johnny (Appointed 22 January 2013)	Member	KPMG
Mr. OR, Ming Chiu (Appointed 22 January 2013)	Member	Mazars CPA Limited
Mr. POON, Tsun Wah, Gary	Member	Poon & Co.
Mr. TAM, King Ching, Kenny	Member	Kenny Tam & Co.
Miss TANG, Kwan Lai	Member	SHINEWING (HK) CPA Limited
Mr. TSUI, Hon Man (Appointed 22 January 2013)	Member	Crowe Horwath (HK) CPA Limited
Ms. YAM, Hoi Yin, Cecilia	Member	BDO Limited
Mr. YAU, Yin Kwun, Joseph	Member	C K Yau & Partners CPA Limited

Members of the Professional Standards Monitoring Expert Panel in 2013

Name	Position	Company
Mr. CHENG, Chung Ching, Raymond	Member	HLB Hodgson Impey Cheng
Ms. CHEUNG, Sau Ying, Olivia	Member	Hong Kong Exchanges and Clearing Limited
Mr. CHOW, Siu Lui, Jack	Member	VMS Investment Group
Mr. DEALY, Nigel Derrick	Member	PricewaterhouseCoopers
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Mr. HO, Che Kong, John	Member	Leighton Asia Limited
Mrs. MORLEY, Catherine Susanna	Member	KPMG
Mr. PANG, Wai Hang, Arthur (Appointed 22 January 2013)	Member	SHINEWING (HK) CPA Limited
Mr. TAYLOR, Stephen	Member	Deloitte Touche Tohmatsu
Ms. YAM, Hoi Yin, Cecilia (Appointed 22 January 2013)	Member	BDO Limited
Mr. YAN, Yiu Kwong, Eddy	Member	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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