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

Quality Assurance
Annual Report 2010

Content

Foreword

Fellow members

This is the report on the activities of the quality assurance department during 2010, which as with previous annual reports, explains the work carried out under the practice review and professional standards monitoring programmes and addresses significant or common findings from our reviews. To ensure that important matters are brought promptly to the attention of members, some of these findings have already been communicated through technical alerts.

We achieved our targets during 2010 and indeed increased the volume of reviews carried out under both programmes. We are now well into the second cycle of practice reviews of listed company auditors and will complete this cycle by the end of 2012 to meet our commitment to international standards of auditor regulation.

An issue that we took particular interest in during 2010 was the application of professional scepticism in the audit process. There has been added emphasis to this matter in the clarified HKSAs, particularly in relation to risk identification and assessment of key management assumptions and judgements. We are aware that professional scepticism is a topical debate internationally. We will stay involved in the debate and will communicate matters of importance to Hong Kong as they become apparent.

During 2010 the issue of non-CPAs offering audit services, sometimes under the cover of a CPA, was highlighted again as a matter of serious concern, particularly in its adverse impact on small- and medium-sized practice members. The Institute has reacted to this concern in a number of ways and under the practice review programme we have paid particular attention to circumstances that suggest a member might be involved in such arrangements. There is reference to this in the report.

As we move into the fifth year of the revised practice review programme, the quality assurance department and the practice review committee expect to see a general rise in the quality of audit work and compliance with professional standards. A lot of supporting material and guidance has been published to assist members raise standards and it is their professional responsibility to maintain appropriate levels of competence, individually and for their firms. We are also reviewing more and more firms, not just listed company auditors, for a second time. As was made clear in the 2009 report, and has been repeated in other publications, the practice review committee takes a dim view of firms that do not take appropriate steps to address issues identified in previous visits and in 2010 have considered the option of referring a few firms to the Institute's disciplinary process.

Auditor regulation in Hong Kong is under review and changes are likely to be made to ensure that the structure of the system in Hong Kong is fully accepted internationally. The Institute is committed to the highest levels of quality in auditing and financial reporting in Hong Kong and will support any necessary changes to auditor regulation that helps Hong Kong maintain its reputation.

Finally, I would like to thank all members who that have shown their own commitment to quality auditing and financial reporting through co-operation with, and positive reaction to, our programmes of quality assurance. We ultimately rely on our members' professionalism to ensure that our programmes are effective and our aims are achieved.

Chris Joy
Executive Director, Hong Kong Institute of CPAs
March 2011

Our work

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

Practice review

Practice review is a quality assurance programme that monitors all practising certificates holders in Hong Kong engaging in provision of audit and other related assurance services ("Practices"). Practice review was introduced by the Institute in 1992 under the authority and powers granted by the Professional Accountants Ordinance ("PAO"). In 2006, the practice review programme was revamped taking into account international developments in auditor regulation and professional standards.

The results of the reviews carried out on Practices by the QAD are reported to the Practice Review Committee ("PRC" or "Committee") which is the committee responsible for exercising the powers given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. By law, at least two thirds of the Committee must hold practising certificates. The practising members of the Committee are drawn from the full spectrum of audit firms. Non-practising members are also included in the Committee to bring an additional level of impartiality to Committee decisions on the quality of work carried out by Practices subject to review. The Nomination Committee of the Institute reviews the composition of the Committee every year and recommends new Committee members as appropriate to ensure a balanced composition. Please refer to Annex for the members of the PRC.

Professional standards monitoring

Another area of responsibility of the QAD is to review published financial statements of listed companies in Hong Kong under the professional standards monitoring programme ("PSMP"). The aim of the programme is to enhance the overall quality of financial reporting in Hong Kong. The primary focus of the programme is educational. However, if the QAD identifies potential non-compliance with accounting standards, enquiry letters are issued to members, primarily auditors of listed companies. In the course of correspondence, QAD may suggest ways to improve disclosures and other elements of financial reporting. Response to our recommendations is generally positive and we have been able to observe amendments in subsequent financial statements as a result of advice given. The process of dealing with more complex cases and disagreements is described later in this report.

PSMP is a comprehensive and extensive financial reporting review programme carrying out regular reviews of financial statements which are selected from a population of all listed companies in Hong Kong. It is supported by the technical expertise of Professional Standards Monitoring Expert Panel ("PSMEP" or "Panel") and external reviewers from Big Four and medium sized practising firms. PSMEP is an expert advisory group comprising members from Big Four firms, medium-sized practitioners, non-practising members and representative of Hong Kong Exchanges and Clearing Limited ("HKEX"). Significant, complex or controversial issues arising from reviews will be referred to Panel members for their views on application of professional standards. Advice is also given by Panel members on how to formulate questions to members and assess members' responses. With the strong and close support of Panel members, the QAD ensures that all the questions raised under the programme are relevant and have been developed after due and careful consideration.

As for the PRC, the composition of the PSMEP is reviewed by the Nomination Committee on a yearly basis to ensure an independent and balanced composition of the Panel. Please refer to Annex for members of the Panel.

The results of both programmes provide valuable content for the Institute's member learning and development activities. Direct interaction with members on auditing and financial reporting matters is a very effective way to give advice and assistance on the application of professional standards. Both programmes remain an important part of the Institute's role to support members and serve the wider public interest by ensuring that the quality of auditing and financial reporting in Hong Kong is maintained and enhanced.

Oversight of our work

The Standards and Quality Accountability Board ("SQAB") was set up in January 2009 to take responsibility for oversight of the activities of the QAD and ensures that activities are being 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 of the Institute and reports to Council on its observations and views in relation to performance and operations. Please refer to Annex for members of the SQAB.

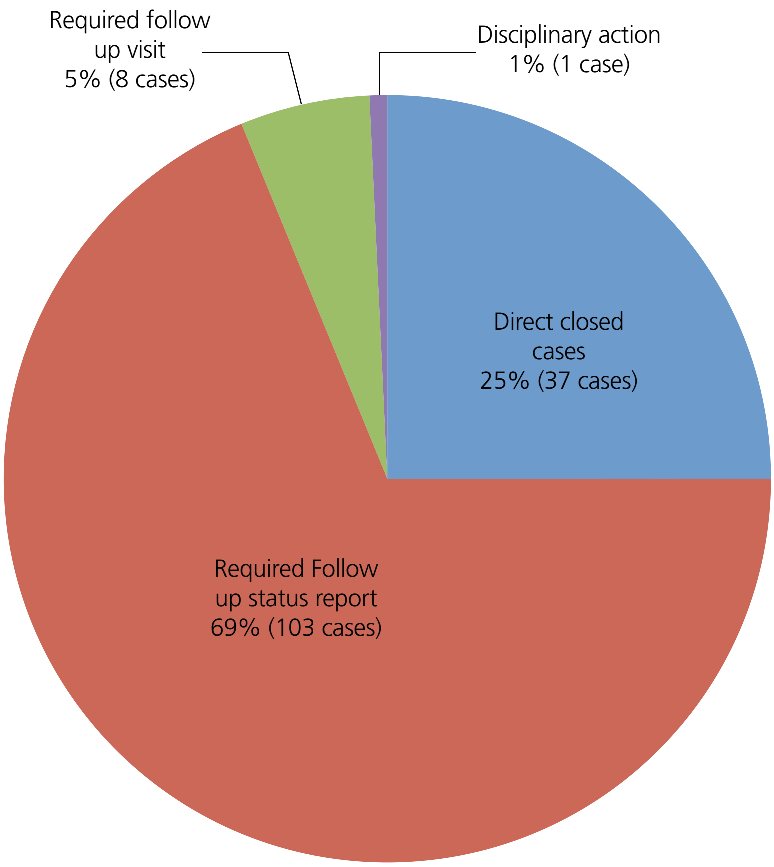
Our achievements

Practice review programme

Since the launch of the revised practice review programme in 2007, the number of reviews carried out every year had increased steadily from 82 reviews in 2008 to 152 reviews in 2010.

By the end of 2009, six months ahead of the three year target to which we are committed, the QAD completed the first review cycle of all Practices with listed clients. The second three-year review cycle of Practices with listed clients commenced in 2010. From 2011, in addition to the current arrangement of one "full" review at least every three years, an "interim" review during the cycle will be introduced to Practices, other than the Big Four, which have a significant number of listed clients.

The PRC met on eleven occasions in 2010 and reviewed reports on 149 Practices. The PRC concluded that 37 cases should be closed without requiring any follow up action. In 103 cases, Practices were required to submit a status report on actions taken in response to the findings to the QAD within a requested period of time. Eight cases required a follow up visit to assess the effectiveness of remedial action taken by the Practices. This was in line with the PRC's intention to give Practices a chance to improve on identified weaknesses in procedures and conduct of audit work. Disciplinary action will be a last resort reserved for those Practices that have serious practice review findings of non-compliance with professional standards or serious levels of technical incompetence. One review in 2010 has resulted in a complaint raised by the PRC for action under the Institute's disciplinary process.



Practice review cases reported to PRC in 2010

In addition to the 149 "first time" practice reviews, eight follow up visits were reported to the PRC in 2010. One was closed on the basis of adequate remedial action having been taken, six required further follow-up actions and for one case PRC has concluded that a complaint will be raised against the Practice.

The QAD received and evaluated 107 remedial action plans and progress reports from Practices that provided information on their progress in addressing findings identified in practice reviews carried out in 2009 and early 2010. These cases were reported to the PRC and 103 cases were closed. The remaining four cases will require a follow up visit in 2011 to further assess the effectiveness of remedial action taken by the Practices.

Professional standards monitoring programme

The QAD achieved its targets in 2010 which represented a considerable increase in the total number of reviews as compared to 2009. There were increases both in number of new financial statements reviewed and number of cases concluded. In 2010, the QAD reviewed 132 sets of new financial statements (2009: 69) and handled 66 auditors' responses (2009: 68). 82 letters (2009: 106) were issued to Practices and 143 (2009: 79) cases were closed.

In 2010, the QAD consulted with Panel members on twenty occasions. The consultations sought advice on complex or controversial issues arising from reviews of financial statements and the content of educational publications (e.g. Financial Reporting and Auditing Alerts) before issue to members.

One case involving more significant departures from relevant accounting standards was referred to the compliance department of the Institute for consideration by the Professional Conduct Committee ("PCC"). The case is currently under the assessment and is expected to be concluded in 2011.

One case involving potential non-compliance with an accounting standard was referred to the Council of the Institute and referred to the Financial Reporting Council ("FRC") for investigation.

Our review process

Practice review programme

Preparation

- Select Practice for visit
- Agree on visit date and request key documents
- Preliminary assessment on submitted key documents

On-site visit

- Opening meeting
- Conduct interviews
- Review compliance with HKSQC1 and review selected audit files
- Summarise findings and recommendations
- Exit meeting

Reporting

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

Practices are selected for Practice Review according to their risk profile. Practices with listed clients have distinct risk profiles and are reviewed on a more frequent basis. The Big Four firms, with the predominance of listed and other public interest entities in their client portfolios, are subject to a review annually. Other Practices with listed companies are subject to a review at least every three years. From 2011, an "interim" review during the three year cycle will be introduced for those with a significant number of listed clients. Selection of other Practices will be based on the assessment of their risk profiles, primarily from information obtained from the electronic self-assessment questionnaire and other relevant sources of information. The QAD will also select some Practices on a random basis to ensure that all Practices will have a chance of being selected for practice reviews.

Practices selected for review are normally advised of the visit date several weeks before the visit date and requested to provide certain information in advance of the visit. The QAD makes a preliminary assessment of documents provided before on-site review.

The scope of each review includes obtaining an understanding of the Practice's system of quality control, assessing the effectiveness of the system in achieving compliance with HKSQC 1 and assessing compliance with professional standards in the operation of quality control policies and conduct of audit work.

Practice reviewers enquire, discuss and agree findings with the Practices in respect of matters identified through the course of the review. A formal presentation of significant matters, which have already been discussed in detail during the course of the review, will be made in the exit meeting.

After the exit meeting, the QAD sends each Practice a draft report that communicates the findings of the review. The Practice is asked to provide a formal written response to the matters raised in the draft report. The QAD is responsible for drawing conclusions on the review and making recommendations to the PRC for consideration and decision. Each Practice is sent a formal notification of the PRC decision that may include specific requests to ensure appropriate steps are taken to address weaknesses and shortcomings identified by the review. The QAD monitors the progress of the follow up actions undertaken by the Practices at the direction of the PRC.

Professional standards monitoring programme

External review

- External reviewers carry out initial review on published financial statements assigned by QAD

QAD review

- QAD reviews reports prepared by external reviewers and decides appropriate actions for the case
- QAD consults Panel members on significant, complex or controversial issues

Follow up

- QAD reviews reply letters from members and decides appropriate actions for the case
- QAD consults Panel members on significant, complex or controversial issues

The approach to the review programme can be summarized as follows:

a. *Risk-based review approach*

Under the risk-based review approach, the QAD took into account the following factors in selecting published financial statements for review by external reviewers:

- newly listed companies;
- companies which have significant changes in share prices;
- companies with recent changes in auditors;
- companies with recent changes in those charged with corporate governance;
- companies which have primary operations in Mainland China; and
- companies which have media coverage indicating that there may be potential problems.

A substantial portion of financial statements were also selected on a random basis to ensure that all listed companies have a chance of being selected for review.

b. *Educational approach*

The QAD understands that application of new or revised standards is often challenging. Therefore the programme places emphasis on the initial application of new or revised standards and aims to provide educational assistance to members applying new standards.

There were more than ten new/revised accounting standards and interpretations which became effective for financial statements for annual periods beginning on or after 1 January 2009 and several more standards issued but not yet effective that allowed early adoption. The QAD assessed the potential accounting implications of each of those standards and noted that some of them have particular relevance to certain types of industries. Therefore an "industry theme" was also brought into our selection process in 2010.

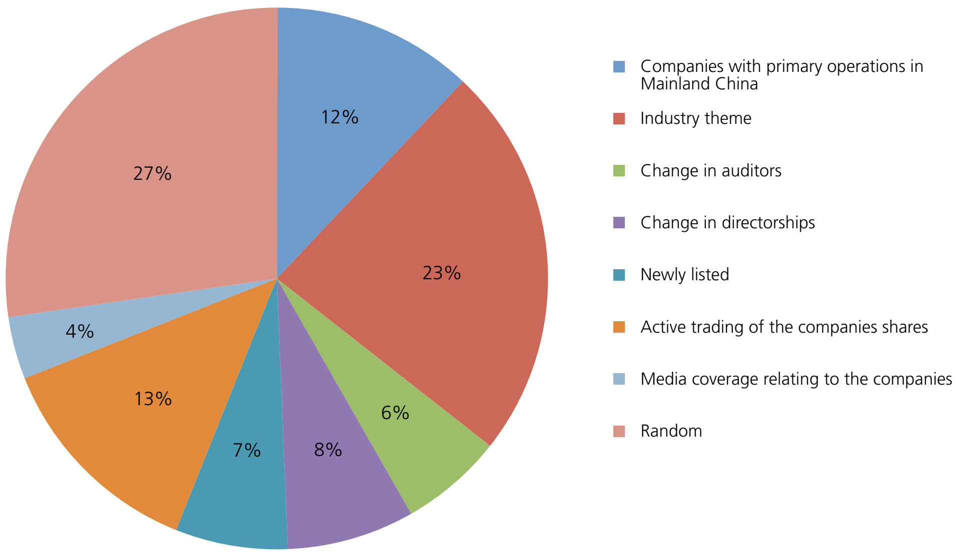
For example, Amendments to HKFRS 7 *Improving Disclosures about Financial Instruments* may be particularly relevant to those companies dealing with financial instruments in their business operations. Therefore, the QAD has reviewed approximately 10 sets of published financial statements of banks, insurance companies and securities dealing companies. Please refer to "Findings and educational points from professional standard monitoring programme" for the educational points noted from initial applications of new or revised standards/interpretations.

The following are the industries which were expected to be mostly affected by certain new/revised accounting standards and have been given priority in reviews:

- Financial institutions: banks, insurance, securities dealing companies
- Companies engaging in infrastructure activities
- Companies engaging in property development
- Airline companies
- Retail companies
- Utility companies

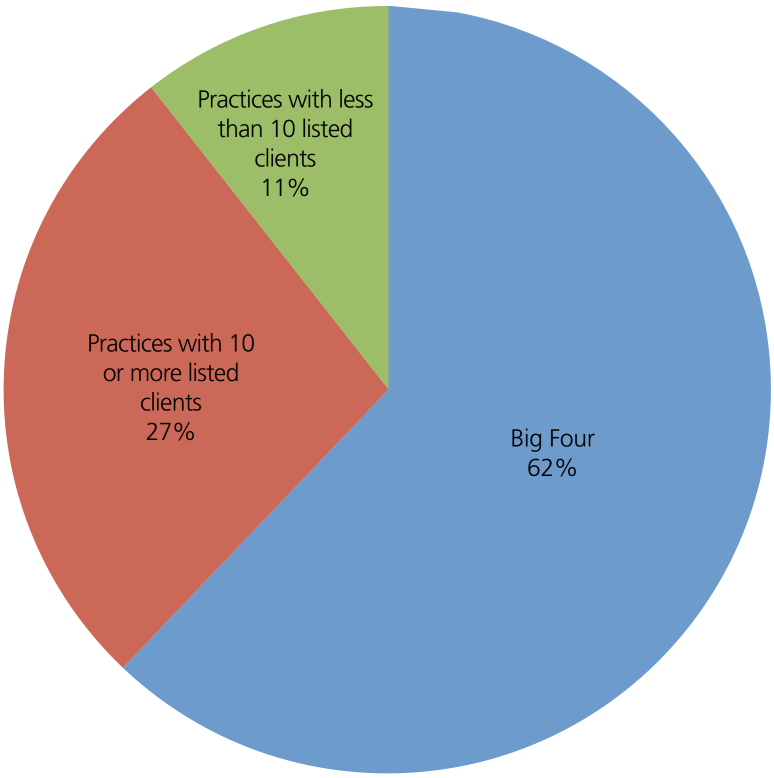
The QAD reviewed 132 new sets of published financial statements under the professional standards monitoring programme in 2010. The following chart summarizes the basis for selection as described above.

Basis for selection



c. *Selection based on market share by auditors*

At the beginning of 2010, based on information obtained from HKEX, the QAD planned the number of financial statement reviews in proportion to the market share of individual auditors. That means auditors which have more listed clients will have a higher chance of the financial statements audited by them being selected. The following chart provides an overview of distribution of auditors in respect of the 132 financial statements reviewed in 2010.



All findings and educational points noted by external reviewers are reviewed and assessed by the QAD. Follow up action on points raised include issuing enquiry letters to seek members' explanations of the issues noted and letters pointing out areas for improvement. If there is no significant issue identified in the initial review, no letter will be issued and the case will be closed.

On the basis of responses received to initial enquires, a decision is made on whether the case can be closed or requires further enquiries. Panel members are consulted if there are significant, complex or controversial issues identified during the review process.

If, at the end of the process, there is an unresolved and significant departure from professional standards, a complaint may be raised for consideration by the PCC. As reviews are primarily of listed company financial statements, these cases may ultimately be referred to FRC.

Cooperation with FRC and HKEX

To avoid duplication with the current review programme of FRC, the review programme does not include financial statements on which qualified/modified audit reports were issued. We understand that FRC will expand the scope of its review published financial statements in 2011. HKEX also has a financial reporting review programme which is similar to professional standards monitoring programme.

Our reviews do not cover compliance with disclosure requirements of the Listing Rules as this function is carried out by HKEX.

To avoid duplicating reviews carried out by FRC and HKEX, the QAD maintains regular communication with FRC and HKEX. The QAD will also explore opportunities to organize joint events with FRC, HKEX and other regulators (e.g. SFC) so that members can obtain maximum benefit from the programme.

Support and assistance to members

While practice review in particular has a primary regulatory function, the work of the QAD is also used to assist members to improve their understanding and application of professional standards and raise the quality of auditing and financial reporting in a positive and constructive way. The QAD provides support and assistance to members through various channels:

a) The QAD hosted two forums in August 2010 which drew approximately 600 attendees. The forums guided members through the quality assurance annual report and discussed common issues identified from practice review and professional standards monitoring.

b) The participation of the Executive Director in the Small and Medium Practitioners Symposiums in October 2010, with approximately 300 attendees, to share various common issues identified during practice review.

c) Five Financial Reporting and Auditing Alerts were published in 2010 which addressed key findings identified from reviews of Practices with listed clients under the practice review programme and reviews of financial statements of listed companies under the professional standards monitoring programme.

d) In May 2010, the QAD introduced an initiative to promote an understanding of the meaning and need for audit quality. The Institute recognizes the importance of audit quality and the strength of the audit profession in maintaining public confidence in capital markets and is committed to helping auditors and other stakeholders understand audit quality and the value of audit. Two publications, "Audit Quality" and "Audit Committees and Audit Quality", were published in May 2010.

e) The QAD provided input and suggestions to the revision of the Institute's Audit Practice Manual ("APM"). The revised APM, which was issued in November 2010, was updated to address the requirements of Clarified Hong Kong Standards on Auditing which were effective for audits of financial statements for periods beginning on or after 15 December 2009.

f) The QAD continues to provide up-to-date information and enhance transparency of the process of both review programmes through the Institute's website (http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/).

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

Looking forward, the QAD will continue to provide support activities to members.

Findings and educational points from practice review programme

This section sets out a summary of common issues identified during the course of reviews carried out in the period covered by this report. The issues raised should be of interest to all Practices involved in auditing and may assist them in revising their audit approach and procedures where they recognize the situations as potentially applying to them.

For most Practices, there has been a gradual improvement in quality control procedures and audit methodology over past few years. Nevertheless, there are still a number of common issues, many of which have been raised in previous reports. The most commonly occurring or significant are set out below.

Practices should be aware of the need to exercise professional scepticism throughout the course of an audit, particularly when reviewing management's judgements and representations. Professional scepticism is an important concept and has been given greater emphasis and prominence in the clarified auditing standards. Practices should ensure a stronger and more visible "tone at the top" that emphasizes the importance of exercising professional scepticism and staff training should develop and reinforce scepticism. Our work has raised some questions on the degree of scepticism that is being exercised and these are identified in the summarized findings below.

Section I – Quality Control Procedures

1. *Quality control manual*

To meet the requirements of HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, many Practices have adopted the Institute's "A Guide to Quality Control". However, a number of Practices did not tailor the guide to suit their circumstances and inconsistencies were noted between procedures in practice and set out in their manuals. We have emphasized over the past few years that the guide is not a mandatory document that has to be applied word for word. The guide is intended to help practitioners understand and efficiently apply HKSQC 1 and therefore practitioners should consider the application of quality control in the context of their own practices and tailor the guide accordingly.

Practitioners are reminded that policies and procedures adopted need to be appropriate to the size and operating characteristics of the Practice while addressing the principles of HKSQC 1. The QAD will assess and review a Practice against the requirements of HKSQC 1.

2. *Acceptance and continuance*

Most Practices use standard acceptance and continuance checklists from the guide to show that an assessment of risks and other key factors was carried out prior to accepting a new / recurring client. However, instances were noted where some practitioners were unable to show how they considered all relevant risks associated with providing assurance services e.g. client's reluctance to allow contact with the previous auditor, implications of prior year audit qualifications and consideration of ongoing limitation of scope qualification. Practitioners are expected to display a level of professional scepticism in making their assessment of whether to take on a new client/engagement or continue with an existing one. When making a decision to continue to act for a client, practitioners should carefully consider previous experiences with their client as well as recent changes. Changes that are particularly significant include rapid modification in the client's operations and altered management behavior. A deteriorating financial condition and an adverse change in management integrity are also important factors to consider. Practices must avoid completing a checklist in a cursory manner without giving the "real" issues proper consideration.

Client and engagement acceptance and continuance decisions are vitally important to Practices as these decisions affect the Practice's profitability and risk exposure. Careful client acceptance and engagement continuance practices can help practitioners manage the risks of being associated with certain clients, in particular for engagements such as IPO, listed or regulated entities. Practices should carefully assess how to comply with relevant ethical requirements and whether they have appropriate levels of experience and competence to understand and handle complex business transactions and accounting issues which commonly exist in these entities. Accepting a "wrong" client can be costly to an audit firm as it could potentially cause a loss of reputation to the Practice, financial loss or even lead to disciplinary sanctions if problems occur with the audit.

3. *Engagement quality control review*

Engagement quality control ("EQC") review is required on all listed audit engagements. Instances were noted where some EQC reviewers did not fully understand the review scope, e.g. they only performed a very high level review on draft audited accounts and did not adhere to policies requiring review of audit planning memo, audit work papers relating to critical audit issues and audit completion memo. Instances were also identified where some Practices did not clearly set out the scope of EQC review and the timing of involvement of EQC reviewers in listed audit engagements.

EQC review is a pre-issuance review that provides an objective evaluation, before the date of the auditor's report, of the audit team's significant judgments and the conclusions they reached in formulating the auditor's opinion. Therefore, it is important to conduct an EQC review properly and in a timely manner at appropriate stages during the engagement and prior to the issuance of the audit report. Practices should also clearly communicate to EQC reviewers their role and scope of work and EQC reviewers must adhere to relevant policies and procedures.

In some cases, we identified that individuals without sufficient experience acted as EQC reviewer for listed engagements. Given the risk exposure and complexity of listed engagements, Practices with listed clients should assign qualified personnel with appropriate experience and authority to act as EQC reviewer on audits of financial statements of listed clients. Practices are also reminded that the EQC reviewer should not be a member of the audit team, who has been involved in other aspects of the engagement.

In addition to listed engagements, Practices should also consider if EQC review is necessary for regulated entities or other public interest entities and special engagements which are usually subject to higher risks and compliance with rules and requirements of regulatory bodies.

4. *Rotation of key audit personnel*

Some small Practices had not rotated the engagement partner and EQC reviewer for listed engagements after seven years as required by the Code of Ethics for Professional Accountants (the "Code"). Under the Code, the rotation of the engagement partner and EQC reviewer is mandatory after seven years with two years' cool-off period after such time. During the cool-off period, the individual should not participate in the audit or provide consultation in relation to quality control or technical issues for the listed client. Practices with listed clients should ensure they have sufficient resources to implement a partner rotation policy and have personnel with sufficient technical expertize and experience to carry out an effective EQC review.

The revised Code, effective from 1 January 2011, has extended the rotation requirements to other key audit partners (apart from the engagement partner and EQC reviewer) in the audit team who make key decisions or judgments on significant audit matters. These may include audit partners responsible for significant subsidiaries. Practitioners are reminded to assess the implication of the revised Code when they plan their audits in future.

5. *Monitoring function*

HKSQC 1 applies to all Practices and there is no exemption on the grounds of size or nature of client base. However, a number of smaller Practices still have not implemented a monitoring function. Practitioners who find it difficult to carry out the monitoring function as a result of limited internal resources should consider pooling of resources and knowledge with other firms in a similar position to carry out the monitoring review. We fully understand the challenges faced by sole practitioners in developing monitoring procedures and we acknowledge the importance of allowing flexibility for them in this aspect. When there is no other alternative, self-monitoring by sole practitioners may be possible if they can manage to perform the monitor role objectively. There are clear limitations in the effectiveness of self-review but we would rather see Practices recognize and seek to apply the principles of HKSQC 1 than ignore such an important element of the standard.

Instances were identified where some smaller practitioners carried out the monitoring reviews as a reaction to the practice review e.g. completing forms and checklists shortly before or during the course of the practice review without thoroughly reviewing audit files and quality control policies and procedures. In these situations, there is significant doubt that an effective monitoring has taken place.

The QAD has the following suggestions for further improvement for practitioners who have implemented monitoring functions:

- Monitoring reviews should cover both a review of compliance with the practice's overall quality control policies and procedures and "completed" audit engagement file reviews.
- Proper documentation of procedures and results of reviews of quality control procedures and the completed audit engagements to evidence that the monitoring function has been properly carried out.
- It would be more meaningful to include high risk clients e.g. listed and regulated clients, in the sample of engagement file review if the Practice has this type of client in its client portfolio.
- Proper follow up action on recommendations proposed by monitors is required.

6. *Independence*

In some smaller Practices with one or few listed clients, total fees from listed clients may represent a large proportion of the Practices' total fees. Dependence on that client or client group and concern about the possibility of losing the client may create a threat to independence. The revised Code provides that if total fee income from a listed client and its related entities represent more than 15% of total fees received by the Practices for two consecutive years, Practices should disclose this fact to those charged with governance of the listed client and consider what safeguards can be applied to reduce the threat to an acceptable level, such as external pre-issuance review and/or post-issuance review on audit engagements. If no appropriate safeguards can be put in place, the Practices must consider not accepting or resigning from the engagement.

7. *File assembly*

Practices are reminded that they should assemble all audit work papers (electronic and manual) within 60 days of the date of the auditor's report. Instances were noted where Practices do not have procedures for final assembly of audit files and solely rely on staff self-discipline to handle the filing. It was not uncommon to see that working papers on significant audit areas were not in the audit files but were kept by members of audit teams. Also, when Practices use electronic audit files, instances were noted where significant supporting documentary evidence was not found in manual audit files or archived soft copy. Examples included work papers on tests of controls and internal consultation memos on key accounting issues.

It is important that Practices establish file assembly policies and procedures and ensure their staff follow procedures so that sufficient audit evidence is obtained and reflected in audit files.

Section II – Audit Methodology and Procedures

1. *Audit methodology*

Some practitioners continue to use audit programs and checklists that were produced many years ago and have often not been updated to address requirements of current professional standards. Particular omissions include programs and checklists to address identification of and responses to audit risks, fraud risk assessment, going concern considerations, internal control evaluation and subsequent event review procedures. In some extreme cases, audit programs still referred to Statements of Standard Accounting Practice, old Statement of Auditing Standards or overseas auditing and financial reporting requirements. Practitioners should regularly review audit programs and checklists to ensure that they are up to date and appropriate to the firms' circumstances and client base.

In some cases, although the Institute's APM had been adopted, practitioners simply followed templates from the APM and did not tailor them for individual audit engagements. The APM incorporates standard audit procedures and documentation to facilitate efficient and effective compliance with professional standards. Practitioners should tailor and complete programs and checklists according to the nature of engagements, client's business and circumstances. Practitioners should also provide adequate guidance and assistance to staff carrying out audit procedures and set out clear guidelines for the use of audit programs.

In respect of audits of regulated entities, such as insurance brokers and securities brokers, we saw many cases where special audit requirements had not been considered. For example, there was insufficient evidence of considerations and conclusions to support issuance of the compliance report as required by PN 820 *The Audit of Licensed Corporations and Associated Entities of Intermediaries* or PN 810.1 *Insurance brokers – compliance with the minimum requirements specified by the Insurance Authority under sections 69(2) and 70(2) of the Insurance Companies Ordinance*. For instance, in audits of securities brokers, appropriate work had not been performed on financial returns submitted in accordance with the Securities and Futures (Financial Resources) Rules. Some practitioners did not qualify their opinion on the compliance report where discrepancies and reclassifications between the submitted financial returns and financial statements were identified. For insurance brokers, some practitioners did not perform work as required by PN 810.1, such as reviewing the minimum capital requirements and professional indemnity insurance, and whether the client maintained separate client accounts and kept proper books and accounts. Practitioners should pay closer attention to the guidance and recommended procedures of the practice notes.

2. *Audit planning and risk assessment*

In some cases, the audit plan only included a brief description of the client's business and did not identify key features of the client's business cycles.

Planning is critical to ensure that all audit risks are identified and appropriate procedures developed to address the risks. It is important that auditors carry out their planning with an open mind and an appropriate degree of scepticism.

There was also often no documentation of evaluation of design and implementation of key controls.

In other cases, even where an audit program "Review of design and implementation of controls" had been completed, the evaluation was not effective because it simply followed wordings in the APM template and did not address actual key controls of the client's business.

Practitioners are reminded to record the system of internal controls for major business cycles as required by HKSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. In order to confirm their understanding of the client's system and evaluate identified key controls, practitioners should trace samples of transactions from origination to ultimate recording in the accounting records.

When a client relies solely or heavily on computerized systems in business operations and financial reporting systems, practitioners should evaluate the effectiveness and reliability of the computerized system before placing reliance on reports generated by the system. Practitioners should also perform audit work to assess whether there was effective control over transfer of data from the computerized operating system to the accounting system. For instance, when a client provides an on-line trading platform for internet trading which is integrated with the accounting system, practitioners should obtain an understanding of the client's computerized business environment and test the integrity of data transferred between the systems.

Issues in relation to consideration of fraud risks continued to be identified at small Practices, in particular the failure to identify the presumed significant risk of fraud related to revenue recognition. Another area of fraud risk in which insufficient work was undertaken was testing of journal entries.

3. Subcontracting arrangements

The use of subcontractors by Practices is fairly common, particularly by smaller Practices, to enable access to flexible additional resources. Many small Practices and sole practitioners subcontract a substantial amount of audit work to other Practices or individuals either in or outside Hong Kong. Practitioners must bear in mind that subcontracting audit work does not reduce the responsibility of the Practice for the audit opinion. Some examples where Practices did not exercise appropriate control over the quality of work of the subcontractors are as follows:

- Subcontractors failed to follow the Practices' audit methodology and quality control procedures when performing audit work;
- Insufficient audit documentation and lack of evidence of work performed and reviewed by the practitioners; and
- Queries raised by practitioners were not properly followed up by subcontractors before the audit opinion was issued.

In some cases, the arrangement between Practice and subcontractor was not formalized and there was no clear delineation of respective responsibilities e.g. scope of work, supervision arrangements, requirements regarding competence, confidentiality and independence, and ownership of audit files.

The following considerations should be addressed by practitioners when they have, or are considering entering into, a subcontracting arrangement:

- The need for a formal agreement with the subcontractor that includes definition of subcontractor's role and responsibilities;
- The need to ensure the subcontractors follow their audit methodology and quality control procedures when performing an audit; and
- Consider whether they have sufficient time and resources to effectively manage subcontractors to ensure that audit work is carried out in compliance with all applicable professional standards.

When "problems" occur with the audit that could potentially cause a loss of reputation to the Practice, financial loss or even lead to disciplinary sanctions, use of a subcontractor is not a defense.

We are also aware of the existence of "tang zai" or "sampans" arrangements in the market where some members are colluding with unlicensed agents or middlemen by signing off on the agents clients' audits where all the work was done by uncertified firms whom are not conversant with current accounting and auditing standards and the quality of audit work is being undermined. We will check on Practices suspected of partnering or receiving subcontracted auditing work from unlicensed firms. Practitioners who fail to comply with the Code of Ethics and professional standards when performing audits are may be subject to disciplinary action and may risk losing their licence.

4. *Group audit arrangements*

Issues were often identified in relation to the extent and sufficiency of audit work performed for a group audit when it involved the use of component auditors. The followings are typical issues identified during our review:

- The group auditor did not assess the component auditors' competence before they placed reliance on component auditors' work;
- The only work done by the group auditor was to obtain component financial information and an audit questionnaire with general "yes" and "no" questions from component auditors without further information of how the component auditors carried out their audits;
- The group auditor failed to follow up on potential audit issues identified by component auditors in their reporting deliverables or did not assess the potential financial impact on the group where qualified opinions were issued at subsidiaries level; and
- Group materiality was lower than the materiality level set for subsidiaries and total unadjusted errors found at subsidiaries level were overlooked and not considered at the group level (See point 6 "Determination of audit materiality" for further details).

With the issue of HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, practitioners should be aware of the expanded guidelines and requirements on group auditors. These include determining materiality in a group environment, determining the type of work to be performed on the financial information of components and communication with both management and component auditors about the group audit process. The changes increase responsibility of the group auditors who are expected to pay more attention to where audit risks lie within the group and have more involvement in the audit of components. As a result of the application of HKSA 600 (Clarified), practitioners may need to revise their audit plans to take into account the extended procedures and train their staff to be prepared for the expanded requirements.

5. *Audit confirmations*

We again identified a number of instances where confirmations were arranged by client personnel. When performing confirmation procedures, Practices should send out the confirmation requests themselves and replies must be sent directly to the auditors. When replies are in the form of fax or other electronic means, auditors should perform all reasonable steps to verify the identity of the sender as required by HKSA 505 (Clarified) *External Confirmations*.

In some cases, circularization was carried out but there was no proper follow up action e.g. assessment of potential financial reporting and audit implications of information other than bank balances disclosed in the bank confirmations, or no alternative audit procedures for non-replies. Practices should perform alternative audit procedures where no response is received to provide audit evidence about the assertions that the confirmation request was intended to address.

6. *Determination of audit materiality*

Instances were identified where some Practices did not apply the concept of audit materiality in planning and performing an audit and in evaluating the effect on the financial statements of identified and uncorrected misstatements. HKSA 320 (Clarified) *Audit Materiality* sets out that, when establishing the overall audit strategy, practitioners should determine materiality for the financial statements as a whole.

In some cases, practitioners determined initial materiality based on management accounts but did not reconsider final materiality. Practitioners are reminded that if a lower materiality than that initially determined is appropriate, they should consider whether the nature, timing and extent of audit procedures carried out remains appropriate.

In a group audit, instances were noted where the audit materiality level applied in the audit of a subsidiary was larger than that determined for the group. In such circumstances, there is a possible risk that misstatements which are considered not significant to the subsidiary but have significant impacts on the consolidated financial statements may be overlooked. In this respect, practitioners are advised to redesign their approach in calculating and applying audit materiality.

There were other instances where uncorrected misstatements identified at subsidiary level were disposed of by practitioners without evaluating the effect of total uncorrected misstatements at consolidation level. There was a risk that the impact of the aggregate misstatements accumulated for the group could exceed materiality. Therefore, practitioners are advised to evaluate the effect of all uncorrected misstatements on the financial statements for the group as a whole.

7. *Audit evidence and related judgements*

We identified issues in relation to adequacy of audit evidence on file to support certain significant balances and related audit judgements. These areas of audit work generally include significant management assumptions and judgement and it is important that auditors display an appropriate level of scepticisim in considering these matters. In particular, we raised issues in a number of key areas, including:

a) *Impairment assessment on assets*

For impairment of goodwill and other intangible assets, we would expect there to be evidence of review of the reasonableness of key assumptions, including forecast revenue and costs, discount rate and growth rate used.

Instances were noted where there was insufficient audit work and explanations as to why no impairment was made when there were indications of possible impairment of a significant asset. For example, where subsidiaries, associates and joint ventures incurred recurring operating losses or the market values of available for sale investments suffered from a significant or prolonged decline, this raises the issue of whether the carrying values of those investments need to be impaired. In another example, goodwill resulting from the acquisition of business was fully written off in the year of acquisition. The above findings suggested that some Practices did not apply sufficient professional scepticism in their consideration of recognition and impairment of goodwill.

b) *Going concern evaluation*

In the event of indications of potential going concern issues, some practitioners relied on management representations to support their conclusion that the use of going concern basis was still appropriate. Practitioners are reminded that they should obtain sufficient audit evidence such as cash flow forecasts to support the going concern assumption. This should involve reviewing the appropriateness of underlying basis and assumptions and applying professional scepticism to challenge the appropriateness of forecasts, such as whether the projection of sales was too optimistic, and that forecasts had incorporated cash in and out flows, e.g. repayment of loans on maturity within the forecast period, etc.

c) *Inventory*

In some engagements reviewed, Practices did not perform appropriate audit work on inventories e.g. physical inventory count was attended at a date other than the year end but the audit team did not perform audit procedures to test transactions during the intervening period. In other instances where inventories were held in different locations, one location with a small proportion to total inventory balances was selected for stocktake attendance with no justification for the basis of selection.

There were also some cases where inventory under the custody and control of a third party was material to the financial statements and practitioners arranged audit confirmations to confirm the quantities and condition of inventory held on behalf of the client. However, they did not follow up non-replied audit confirmations and did not perform alternative procedures to verify the inventory held.

In some cases, practitioners did not assess the appropriateness of costing methods used. Instances were noted where material, labour and overhead costs were incurred for producing goods but absorption into work-in-progress and finished goods only included material costs. Practitioners should perform sufficient audit work to ensure all production costs are properly accrued and absorbed into inventory costs.

In other cases, practitioners assessed adequacy of inventory provisions only through identifying damaged or obsolete inventories during stocktake attendance. They did not evaluate clients' inventory provision policies for damaged and obsolete inventories or assess the appropriateness of the policies based on reliable operational or accounting information such as product life cycle and inventory aging. In some instances, they did not perform adequate audit procedures to test net realizable values of inventory, such as only checking items with insignificant values, undertaking a general review of overall gross profit ratio without checking subsequent market prices of specific items, etc.

8. *Audit Documentation*

In previous reports and forums, we have emphasized the importance of audit documentation. Instances were noted where practitioners did not properly document the rationale that supported accounting treatment of critical matters. Examples of critical matters included business combinations, recognition and impairment of intangible assets and goodwill, recognition and measurement of financial instruments, valuation of assets and revenue recognition. Thought process and conclusions could not be fully understood without obtaining oral explanations from practitioners. In particular, questions were raised where there was no or insufficient evidence in audit files to demonstrate that practitioners had a thorough understanding of complex client transactions and had made a proper evaluation of the appropriateness of accounting treatments adopted by clients.

On some audits reviewed, Practices did not document work performed on significant audit areas such as sales and purchases transaction tests, and cut-off tests. For instance, audit work papers did not state sample selection basis, how tests were performed and test results.

Practitioners are reminded that they must perform sufficient audit procedures and obtain audit evidence to support the audit opinion reached. It is also important that Practices continue to deliver a clear message to partners and staff on the importance of good quality audit documentation which should be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

(a) The nature, timing, and extent of the audit procedures performed;

(b) The results of the audit procedures performed, and the audit evidence obtained; and

(c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

9. Subsequent event review

Many instances were noted where subsequent event review procedures were not updated to the audit report date. Time gaps identified varied from one to six months between the completion of subsequent events audit programme and the audit report date. Practitioners may be missing events which occurred during the intervening period that require adjustment of, or disclosure in, the financial statements.

Practitioners are reminded to perform and record procedures covering the period up to the date of the audit report in accordance with HKSA 560 (Clarified) *Subsequent Events*.

10. Using the work of an expert

Issues were identified when engagements involved reliance on work of experts, e.g. valuations of net assets acquired in business combinations, valuation of share options granted, property valuation, etc. We noted that some practitioners merely obtained a copy of the valuation report as audit evidence without performing any evaluation work as required by HKSA 620 *Use the work of an Expert*.

The usual explanation we heard from practitioners was that the expert was commonly employed for valuations in related industries so they did not feel able to challenge the professional competence of the expert. In some cases, practitioners argued that they did not possess the same expertise and knowledge so that they were unable to challenge the expert's assumptions and methods used.

Practitioners are reminded that, when the engagement involves the use of work of the client's expert, auditors should evaluate whether the professional valuation is reliable for the audit purpose. HKSA 500 (Clarified) *Audit Evidence* contains guidance on using the work of the client's expert as audit evidence which was previously dealt with in HKSA 620.

Under HKSA 500 (Clarified), practitioners should evaluate the professional competence and objectivity of the expert. Matters relevant to evaluating competence, capabilities and objectivity of the expert include whether that expert possessed a recognized qualification in the field of expertise and is subject to ethical requirements. More importantly, practitioners should obtain an understanding of the expert's work, including the assumptions, methods and source data used, and evaluate the appropriateness of the expert's work as audit evidence e.g. justification to adopt market approach instead of income approach for valuation when there are insufficient comparable transactions in the market. Practitioners should consider making inquiries regarding procedures undertaken by the expert to establish whether the source data is relevant and reliable e.g. reasons for not able to conduct a site visit to the asset being valued, extent of limitation of information available for expert's assessment. If necessary, they may review or test data used by the expert.

11. Communication with audit committee

The audit committee has an oversight function over internal controls and financial reporting on listed entities, and serves as a liaison between management and the auditors. There were instances where significant audit matters were summarized in the audit work papers but had not been comprehensively reported to the audit committee.

Practitioners are reminded that the audit committee plays a very important role in the audit process. Effective and regular communication between the audit committee and auditors is beneficial to the overall conduct of the audit and the quality of audit service. All significant matters should be communicated so that the audit committee is aware of key audit issues and the way the issues are resolved. Matters to be communicated are set out in HKSA 260 (Clarified) *Communication with Those Charged with Governance*. They include an overview of planned scope and timing of the audit, significant findings and the auditors' independence.

Practitioners should keep a record of verbal communication with audit committees e.g. nature of the matter, and when and to whom it was communicated. Where matters have been communicated in writing, practitioners should retain a copy of the communication as part of their audit documentation.

Practitioners should also consider the implication of a new requirement under HKSA 265 (Clarified) *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* that they should communicate significant deficiencies in internal control identified during the audit to the audit committee and the client's management.

12. Management representations

There remains a concerning tendency for practitioners to be over-reliant on representations from management on critical matters such as recoverability of significant long outstanding trade debts, underlying basis and assumptions behind cash flow projection for goodwill impairment test, etc.

We would expect practitioners to treat management representations with a degree of scepticism, to challenge assertions made and not accept all representations at face value.

Representations are written statements that management provides to auditors to confirm specific matters of audit importance or to support other audit evidence. However, representations cannot on their own be a substitute for other audit evidence that the auditor could reasonably expect to be available. Practitioners should where possible obtain persuasive audit evidence to validate the representations or explain why representations on their own comprise sufficient and appropriate audit evidence.

Findings and educational points from professional standards monitoring programme

During regular reviews of published financial statements, the QAD identifies common issues in respect of applications of financial reporting standards. From January 2010, the QAD has communicated common deficiencies noted from reviews by means of Financial Reporting and Auditing Alerts to members in a timely manner.

This report sets out other common or topical accounting issues which the QAD considers worth highlighting to members. The first section relates to accounting issues arising from initial applications of new or revised financial reporting standards, amendments and interpretations. The second section discusses application issues on other standards such as accounting for non-current assets held for sale and discontinued operations, determination of useful life of intangible assets and accounting for convertible bonds.

Section I – Initial application of new or revised standards, amendments and interpretations which are effective for annual periods beginning on or after 1 January 2009

In 2010 reviews, the QAD noted numerous deficiencies in respect of initial application of HKFRS 8 *Operating Segments*. In order to help members apply this standard and improve the quality of segment disclosures in financial statements, the QAD issued a separate alert in September 2010. The alert explains the key requirements of the standard illustrated by common observations from reviews of published financial statements. Members can assess the alert by the following link:

http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/financialauditing/2010/fraa-10.pdf

As discussed in "Our review process", some industry sectors were expected to be more affected by certain new standards and therefore have been treated as priorities in the QAD reviews in 2010. This section shares some of common observations from reviews of financial statements of "financial institutions" and "real estate companies".

1. *Financial institutions*

   Amendments to HKFRS 7 *Improving Disclosures about Financial Instruments* have amended disclosure requirements in respect of the fair value of financial instruments and liquidity risk. The amendments introduce a three-level fair value hierarchy (Level 1, 2 and 3) for fair value measurement disclosures. More detailed disclosures are required for financial instruments measured using valuation techniques which rely heavily on unobservable data. The definition of liquidity risk has also been changed to exclude financial liabilities settled in equity instruments or non-financial assets and requires a separate maturity analysis for derivative and non-derivative financial liabilities.

In 2010, the QAD reviewed approximately ten sets of financial statements of financial institutions (including seven banks) which are considered to be mostly affected by the amendments. The following are the common observations:

a. *Contractual maturity analysis – quantitative liquidity disclosures:*

The Standard has been amended so as to specify different liquidity risk disclosure requirements for derivative and non-derivative financial liabilities.

For "non-derivative" financial liabilities, the quantitative maturity analysis disclosure based on remaining contractual maturities is not changed (paragraph 39(a), B11C of HKFRS 7). However, for issued guarantee contracts, the amendments require the maximum amount of the guarantee be disclosed in the earliest period in which such a guarantee could be called (B11C(c) of HKFRS 7).

We noted instances whereby the maturity analysis did not include financial guarantee contracts issued by the company.

For "derivative" financial liabilities, the contractual maturity analyses should show the remaining contractual maturities if they are essential for an understanding of the timing of the cash flows (B11B of HKFRS 7).

It is worth noting that the maturity analysis only applies to financial instruments. The QAD sometimes noted that maturity analyses had inappropriately included liabilities which are not financial liabilities under HKAS 32, e.g. deferred revenue, tax liabilities. On the other hand, maturity analysis for "financial assets" is required when necessary for users to evaluate the nature and extent of the company's liquidity risk (B11E of HKFRS 7).

Members are recommended to refer to B10A to B11F of HKFRS 7 for further guidance on quantitative liquidity risk disclosures.

b. *Three-level fair value hierarchy*

The three-level fair value hierarchy is defined in HKFRS 7 to reflect the significance of inputs used in making measurements.

Level 1	*quoted prices (unadjusted) in active markets for identical assets or liabilities;*
Level 2	*inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and*
Level 3	*inputs for the asset or liability that are not based on observable market data (unobservable inputs)*

The QAD found instances whereby Level 1, 2 and 3 defined in financial statements are not consistent with definitions in the standard. In those instances, it is not clear whether the companies had followed the requirements of the standard to disclose the hierarchy information.

The QAD would also like to draw members' attention to the additional specific disclosures for instruments with fair value measurements that are in Level 3 of the fair value hierarchy. These disclosures inform users of financial statements about the effects of fair value measurements that use the most subjective inputs (BC39F of HKFRS 7). Members should refer to paragraph 27B(c) to (e) of HKFRS 7 for details of disclosure requirements.

2. *Real estate companies*

a. *HK(IFRIC) – Int 15 Agreements for the Construction of Real Estate*

HK(IFRIC) – Int 15 supersedes HK-Int 3 Revenue – Pre-completion Contracts for the Sale of Development Properties. This new interpretation clarifies which standard (HKAS 11 *Construction Contracts* or HKAS 18 *Revenue*) should be applied under different circumstances. The interpretation helps to standardize the accounting practice for the recognition of revenue by real estate developers.

Real estate companies that have previously applied HKAS 11 to recognize property sale revenue as construction progresses, may now need to change to apply HKAS 18 to recognize revenue at a single point of time (i.e. at completion upon or after delivery). The key consideration is whether the agreement provides the buyer has an ability to specify the major structural elements of design, either before or during the construction. If the buyer has that ability, HKAS 11 applies and if not, HKAS 18 applies. Therefore the timing of recognizing revenue may be changed, e.g. if applying HKAS 18, revenue may only be recognized at delivery of properties, being the time when all the criteria under paragraph 14 of HKAS 18 have been met. If applying HKAS 11, revenue may be recognized based on stage of completion of the contract.

Amongst the financial statements of real estate companies reviewed, no change in accounting policy was noted due to implementation of HK(IFRIC) – Int 15. This may because before the introduction of HK(IFRIC) – Int 15, Hong Kong had already developed its own interpretation (i.e. HK-Int 3) which provided similar guidance on when to apply HKAS 11 or HKAS 18 in respect of sale of development properties. Therefore adoption of HK(IFRIC) – Int 15 may not have had a material impact on the accounting treatment of real estate sale if those companies had applied HK-Int 3 previously.

b. HKAS 23 (Revised) Borrowing Costs

- Accounting policy is not consistent with current requirements of standards

  The QAD noted instances, not limited to real estate companies, where the accounting policy for borrowing costs has not been updated to reflect the revised requirements of HKAS 23 and still followed the previous HKAS 23 which allowed an entity to recognize all borrowing costs in profit or loss.

  Members are reminded that the revised HKAS 23 requires an entity to capitalize borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognize other borrowing costs as an expense in the period in which they are incurred.

  In one set of financial statements the accounting policy had been updated to address the revised requirements of HKAS 23 but no capitalization of borrowing costs was noted. It was not clear whether the transitional provisions set out in HKAS 23 (Revised) paragraph 27 were applicable to the entity which expensed all borrowing costs as incurred in the past and therefore it had elected not to capitalize borrowing costs on incomplete construction projects eligible for capitalization which had commencement date "on or before" 1 January 2009. The QAD was concerned that the accounting policy wording may only be boilerplate and not fully address the accounting treatment followed. Members are reminded of the need to ensure that the actual accounting treatment is in line with stated accounting policies.

- Inappropriate rate used to capitalize borrowing costs

  HKAS 23 (Revised) gives guidance on how borrowing costs to be capitalized should be determined. According to paragraph 14 of HKAS 23 (Revised), when a qualifying asset is funded from a pool of general borrowings, the entity shall determine the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditure on the qualifying asset.

  In respect of the determination of capitalization rate, HKAS 23 (Revised) requires that the rate shall be the "weighted average" of borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

  Therefore a "weighted average" capitalization rate should be applied in respect of general borrowing costs. The QAD noted that some companies disclosed capitalization rates per annum which were lower than the interest rates of bank and other borrowings, which seems to be unreasonable if HKAS 23 (Revised) is correctly applied. The QAD would like to remind members to ensure that the capitalization rate is properly determined in accordance with HKAS 23 (Revised).

There are also two disclosure requirements under HKAS 23 (Revised): "*(a) the amount of borrowing costs capitalized during the period; and (b) the capitalization rate used to determine the amount of borrowing costs eligible for capitalization*". The QAD noted that companies generally disclosed the amount of borrowing costs capitalized but often omitted the disclosure of capitalization rate used.

Members are encouraged to read HKAS 23 (Revised) in full for the detailed rules, such as what borrowing costs are eligible for capitalization and the period allowed for capitalization of borrowing costs.

c. *Amendments to HKAS 40 Investment Property*

The QAD found a few examples where the accounting policy for property, plant equipment stated that property that was being constructed or developed for future use as investment property is classified as property, plant and equipment and stated at cost until construction or development is complete, at which time it is reclassified and subsequently accounted for as investment property. This policy would have suggested that investment property under construction is accounted for under HKAS 16 *Property, Plant and Equipment*.

The QAD would like to remind members that as a part of *Improvements to HKFRSs* issued by the Institute in October 2008, HKAS 40 has been amended to require an entity to account for properties being constructed or under development for future use as investment property under HKAS 40, and not HKAS 16. Members may refer to the following publication issued by the Institute for reference:

http://app1.hkicpa.org.hk/APLUS/0907/QA.pdf

Section II – Other common or significant issues

1. *HKFRS 5 Non-current Assets Held for Sale and Discontinued Operations*

HKFRS 5 specifies that a non-current asset or disposal group shall be classified as a non-current asset held for sale when its carrying amount is recovered principally through sale. It further sets out two criteria that must be met before an asset or disposal group can be classified as "held-for-sale". The criteria are (a) it must be available for immediate sale in its present condition subject only to terms that are usual and customary for sale of such assets (or disposal group); and (b) the sale must be highly probable.

The QAD encountered some examples where the company was not able to demonstrate that the sale is highly probable. Some companies disclosed an "intention" to dispose of the assets without commitment to a plan for sale or they expected to complete the sale after one year.

The QAD would like to emphasize that for the sale to be highly probable, paragraph 8 of HKFRS 5 requires that appropriate level of management must be committed to a plan to sell the asset and an active programme to locate a buyer and complete the sale must have been initiated. The sale should also be expected to be completed within one year from the date of classification as non-current asset held for sale. Members should ensure that all the conditions set out in paragraph 8 of HKFRS 5 for a sale of a non-current asset or disposal group are met in order to demonstrate that the sale is highly probable.

The QAD would also like to remind members that "highly probable" is defined in Appendix A of HKFRS 5 as "significantly more likely than probable", where "probable" is defined as "more likely than not".

A non-current asset or disposal group cannot be classified as held for sale if it is held for sale after the reporting period. However, disclosures such as a description of the non-current asset (or disposal group); the facts and circumstances of the sale or disposal; and the reportable segment in which the non-current asset (or disposal group) is presented shall be provided.

Non-current assets or disposal groups classified as held for sale shall be measured at the lower of their carrying amount and fair value less costs to sell in accordance with paragraph 15 of HKFRS 5. The carrying amount of the non-current asset or disposal group is measured in accordance with applicable HKFRSs immediately before its initial classification as held for sale. In other words, an entity should apply its usual accounting policies until the criteria for classification as held for sale are met. Depreciation or amortization of a non-current asset will cease once it has been classified as held for sale.

In cases reviewed, the QAD noted that the carrying amount of non-current assets exceeded the selling price agreed with the buyer but no impairment loss was recognized upon the classification of non-current asset as held for sale. If the selling price is the same as fair value less cost to sell, members are reminded of the requirement of HKFRS 5 to recognize impairment loss for an asset if its carrying amount determined upon classification as held for sale exceeds its fair value less costs to sell.

The QAD would also like to advise members of the need to carefully assess whether non-current assets or disposal groups classified as held for sale meet the definition of a "discontinued operation" under paragraph 32 and Appendix A of HKFRS 5. Where a non-current asset or disposal group classified as held for sale has met the definition as a "discontinued operation", the results (the sum of the profit or loss from discontinued operations for the period and the gain or loss arising on the remeasurement of the assets or disposal of the discontinued operations) of discontinued operations shall be presented in the statement of comprehensive income with an analysis in the notes or in a section of the statement of comprehensive income separated from continuing operations.

Members may refer to Implementation Guidance of HKFRS 5 which provides examples of presentation of discontinued operations in the statement of comprehensive income and presentation of non-current assets or disposal groups classified as held for sale in the statement of financial position.

It is not necessary to restate comparatives for assets or disposal groups classified as held for sale at the end of the reporting period under HKFRS 5. However, for those operations qualified as discontinued operations in the current year, HKFRS 5 requires an entity to re-present the results of those operations for comparative periods.

Paragraph 5B of HKFRS 5 was added by Improvements to HKFRSs issued in May 2009. This standard clarifies that disclosures in other HKFRSs do **not** apply to such assets (or disposal groups) unless those HKFRSs require (a) specific disclosures in respect of non-current assets (or disposal groups) classified as held for sale or discontinued operations; or (b) disclosures about measurement of assets and liabilities within a disposal group that are not within the scope of the measurement requirement of HKFRS 5. Additional disclosures may be needed to comply with the general requirements of HKAS 1, in particular in relation to a fair presentation and sources of estimation uncertainty. An entity shall apply the aforesaid requirements prospectively for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the standard for an earlier period it shall disclose that fact.

2. *Intangible assets*

In some financial statements subject to review the determination of useful life of intangible assets was not in line with the requirements of HKAS 38 *Intangible Assets*.

Paragraph 94 of HKAS 38 requires that the useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, unless there is evidence to support that the rights can be renewed by the entity without significant cost, which is further explained in paragraph 96 of the standard. Members are therefore reminded that the length of validity period of an intangible asset over which an entity can use the assets, is of relevance when determining the useful life of the intangible asset.

In some instances, the QAD noted that the useful life determined for an intangible asset exceeds its contractual period. It is not clear how the entities can have control and be able to generate benefits from the intangible asset beyond the contract period.

In other instances, the QAD noted that intangible assets such as technology know-how has a useful life of 25 years or even as long as 50 years. Paragraph 92 of HKAS 38 states that "*Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life is short*". In view of the presumption on technology obsolescence, it should be uncommon for an entity's technology know-how to have a long useful life. The QAD recommends members take into account factors of technical and technological obsolescence in determining the useful life of an intangible asset.

Paragraph 90 of HKAS 38 also provides examples of factors to be considered in determining the useful life of an intangible asset, such as the expected usage of the asset and product life cycles.

As accounting for intangible assets is based on useful lives, an intangible asset with a finite useful life is amortized while an intangible asset with an indefinite useful life is not subject to amortization but mandatorily subject to annual impairment review. Therefore the determination of useful life of an intangible asset is often a key area. Members are recommended to refer to the Illustrative Examples in HKAS 38 for guidance on determination of useful life for different intangible assets.

The QAD also found some cases where the reasons supporting the assessment of an indefinite useful life for an intangible asset and the amortization rates and method used for intangible assets with finite useful lives were not disclosed. Members are advised to refer to paragraphs 118 to 123 of HKAS 38 for the general disclosure requirements for intangible assets and paragraphs 134 to 135 of HKAS 36 *Impairment of Assets* for significant intangible assets with indefinite useful lives allocated to cash-generating unit(s).

3. *Accounting for convertible bonds*

It is common practice that listed companies issue convertible bonds or notes for different purposes, e.g. fund raising or satisfaction of consideration in business combinations. QAD occasionally identified weaknesses in relation to application of HKAS 32 *Financial Instruments: Presentation* and HKAS 39 *Financial Instruments: Recognition and Measurement* in accounting for convertible bonds.

Some of the more significant accounting issues from the perspective of the "issuer" of convertible bonds are discussed below:

a. *Recognition and measurement*

- Accounting implications of different components embedded in convertible bonds

In some cases, financial statements disclosures and relevant announcements of the companies indicated that convertible bonds issued had multiple components, possibly including embedded derivatives. However it was not clear whether the companies had identified the different components and accounted for them in accordance with applicable accounting requirements.

A common example was an "early redemption option" embedded in convertible bonds. It may be a put option held by the bondholder to require the issuer to redeem the bonds early, or a call option held by the company as bond issuer to allow early redemption before maturity date under specified conditions. In either situation, the option could be an embedded derivative that would require accounting for separately from the host contract if it has met all conditions specified in paragraph 11 of HKAS 39. If any conditions are not met, the embedded derivative should not be accounted for separately. The principle is that an entity is prohibited from separating an embedded derivative that is "closely related" to its host contract. Paragraph AG30(g) of HKAS 39 gives guidance that a call or put option is generally closely related to the host debt contract if the exercise price is approximately equal to the amortized cost of the host on each exercise.

The meaning of "closely related" is not defined in the standard and therefore requires management's judgment to prove whether the component is closely related to the host contract or not. However, the standard provides a series of examples to illustrate situations where the embedded derivative is or is not "closely related" to the host contract (see Section C of Implementation Guidance of HKAS 39). Members should also refer to paragraphs 10 to 13 and AG27 to AG33B of HKAS 39 for guidance on accounting for instruments which contain embedded derivatives.

It is worth noting that from the perspective of an issuer of a convertible bond with an embedded call or put option feature, HKAS 39 requires that the assessment of whether the call or put option is closely related to the host debt instrument is made before separating the equity element under HKAS 32 (see AG30(g) of HKAS 39).

Members will be aware that the accounting treatment for a separated embedded derivative is the same as for a standalone derivative. Such instruments will be recorded on the statement of financial position and fair value changes in value recognized in profit or loss.

When an entity is unable to measure an embedded derivative that is required to be separated from the host contract, paragraph 12 of HKAS 39 requires that the entire contract is designated at fair value through profit or loss.

The QAD understands the concept of "embedded derivative" may be one of the most difficult area for many preparers and users of financial statements to understand as the requirements of standards are complex. The QAD therefore encourages members to read the standards carefully to ensure that convertible bonds are properly accounted.

b. Functional currency of the issuer of convertible bonds

- Functional currency of the issuer is not clear

  In some cases reviewed, the QAD noted that it was not clear what was the functional currency of the company which issued convertible bonds. The QAD would like to remind members that the functional currency of the issuer will have a significant impact on the accounting treatment of convertible bonds. If convertible bonds are issued in a currency that is **not** the functional currency of the issuer, the "fixed-for-fixed" requirement under HKAS 32 is not met and the convertible bonds should be accounted for as financial liabilities under HKAS 32 and subject to HKAS 39 for recognition and measurement.

- Subsequent change in the functional currency of the issuer

  In one example convertible bonds were denominated in the functional currency of the issuer and therefore met the fixed-for-fixed requirement under HKAS 32 on initial recognition. However, the issuer changed its functional currency after issue of the convertible bonds. In this situation, the conversion feature no longer meets the "fixed-for-fixed" notion and therefore cannot meet the definition of equity.

  The above change in circumstance (i.e. change in functional currency of the issuer) prompts the question of whether the equity component of the bond should be reclassified as a financial liability from equity.

  The QAD is aware that there are arguments both for and against reclassification. Therefore there is a lack of definitive general guidance to the above situation. It may be a matter of accounting policy choice, either to reclassify or not to reclassify the instrument following a change of circumstances which, had it occurred before initial recognition of the instrument, would have changed its classification. However, the policy adopted by the entity should be applied consistently in dealing with all changes of circumstances of a similar nature. The judgement applied by the entity should also be disclosed in accordance with the relevant requirements of HKAS 1 (Revised) *Presentation of Financial Statements*.

c. *Insufficient or boilerplate disclosures for convertible bonds*

The QAD often found that disclosures for convertible bonds were insufficient. For example, the disclosures only provided the dates of the relevant announcements or circulars with no details (e.g. contract terms) given of the convertible bonds. Announcements and circulars of listed entities are **not** part of the financial statements and therefore it is not appropriate to assume that readers would refer to the announcements or circulars to understand the convertible bonds.

Members should ensure that financial statements disclosures are sufficient to enable readers to understand the terms of convertible bonds, the accounting treatment and the related financial impact.

Where convertible bonds contain multiple embedded derivatives, the QAD would expect the financial statements to provide sufficient information to explain how these embedded derivatives are accounted for by the company. However, in a few instances, the QAD considered that the accounting policy for convertible bonds was boilerplate with no mention of the accounting treatment of embedded derivatives.

d. *Impact of HKFRS 9 Financial Instruments*

In November 2010 requirements for classification and measurement of financial liabilities were added to HKFRS 9. Members should note that most of the requirements in HKAS 39 for classification and measurement of financial liabilities were carried forward unchanged to HKFRS 9. Under HKAS 39 most liabilities were subsequently measured at amortized cost or bifurcated into a host, which is measured at amortized cost, and an embedded derivative, which is measured at fair value. Consistently with the IASB's objective to replace HKAS 39 in its entirety, those requirements from HKAS 39 are relocated to HKFRS 9 (IN7(a) of HKFRS 9).

Therefore the current accounting for convertible bonds as financial liabilities from the perspective of the issuer of the convertible bonds may not be significantly affected by HKFRS 9.

Nonetheless, the QAD would like to draw members' attention to two substantive changes in the classification and measurement of financial liabilities from the existing HKAS 39 requirements, in relation to the measurement and recognition of fair value changes attributable to own credit when designating financial liabilities at fair value through profit or loss when using the fair value option and derivatives linked to unquoted equity instruments. Members are encouraged to read the new standards carefully before applying HKFRS 9 which will become effective for annual periods beginning on or after 1 January 2013.

Members are also recommended to refer to section 7.2 of HKFRS 9 for the details of transitional provisions in applying HKFRS 9.

4. *Other common disclosures and accounting issues*

Amongst the cases reviewed, the QAD noted some recurring deficiencies which have been reported in previous reports. They relate to applications of HKAS 1 (Revised) *Presentation of Financial Statements*, HKAS 36 *Impairment of Assets*, HKFRS 3 *Business Combinations* and HKFRS 7 *Financial Instruments: Disclosures*. Those deficiencies are summarized below. Members are urged to pay particular attention to them when preparing or auditing financial statements.

a. *Accounting for financial guarantee contracts*

It is still quite common in Hong Kong that companies treat financial guarantee contracts ("FGC") issued to banks in relation to banking facilities granted to subsidiaries as "contingent liabilities". This treatment is generally not in line with accounting policies disclosed in the financial statements – i.e. initially recognize the FGC at fair value under HKAS 39 and subsequently at the higher of the best estimate of the expenditure required to settle the present obligation and amortized amount.

Members should note that information on the maximum amount of exposure of issued financial guarantees is a required liquidity risk disclosure under HKFRS 7. It is therefore not appropriate to classify the FGC as "contingent liabilities" under HKAS 37. Members are also reminded to account for the FGC in accordance with their accounting policy.

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

The following are common disclosures that are often omitted:

- description of critical accounting estimates, assumptions and judgements made by management;
- description of entity's objectives, policies and processes for managing capital;
- accounting policies and treatments used by management in accounting for significant balances or transactions; and
- the nature, amount and reason for reclassification of comparative amounts.

Members are advised to refer to Financial Reporting and Auditing Alert No.6 and our 2009 report in the following link:

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

c. HKAS 36 Impairment of Assets

The following are missing disclosures noted by QAD in relation to impairment assessment of intangible assets including goodwill:

- description of key assumptions (discount rate and growth rate) used in determining the recoverable amount of assets (cash-generating units);
- explanation of substantial changes in key assumptions as compared to previous years;
- sensitivity analysis of how possible changes in key assumptions would impact recoverable amounts; and
- events and circumstances that led to "recognition" or "reversal" of impairment loss. Members are reminded that reversal of impairment made for goodwill is prohibited under paragraph 124 of HKAS 36.

Members are advised to refer to our 2008 and 2009 reports for more details in respect of the disclosures deficiencies of impairment of assets in the link cited in part (b) above.

d. HKFRS 3 Business combinations

The comments here referred to the version of HKFRS 3 issued by the Institute in 2004. The QAD noted that some companies still did not apply the requirements of HKFRS 3 (2004) properly. Particular concerns raised in 2010's reviews were related to (i) measuring the cost of a business combination and (ii) allocating, at the acquisition date, the cost of the business combination to assets acquired (including goodwill) and liabilities and contingent liabilities assumed. The application of HKFRS 3 and related disclosure issues noted by the QAD have been detailed in our previous reports.

A revised version of HKFRS 3 was issued by the Institute in March 2008 which shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. Members are reminded that HKFRS 3 (Revised) has broadened the scope and changed the calculation of goodwill and treatment of contingent consideration and introduces the option to value the non-controlling (minority) interest at fair value. The revised standard also imposes new disclosure requirements as detailed in paragraph B64 to B67.

The QAD strongly recommends members carefully read HKFRS 3 (Revised) before initial application of this standard in financial statements. Members may refer to the staff summary of this revised standard available in the following link:

http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/HKICPAStaffSummaryofHKFRS3.pdf

e. *HKFRS 7 Financial Instruments: Disclosures*

In some cases reviewed, the QAD found that HKFRS 7 disclosures are either missed or addressed by boilerplate disclosures drawn from specimen financial statements published by international accounting firms without tailoring to the entity's circumstances. Areas of missing or inappropriate disclosures were as follows:

- an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired;
- when a valuation technique is used, the methods and assumptions applied in determining fair values of each class of financial assets or financial liabilities;
- disclosures on objectives, policies and processes for managing credit risk and the methods used to mitigate credit risk; and
- disclosures about the entities' liquidity risk exposure such as compliance with loan covenants and amount of unutilized banking facilities.

Members are advised to refer to our 2009 report in the link quoted in part (b) above for reference of common deficiencies noted on HKFRS 7 application. Members are also encouraged to refer to the application guidance in Appendix B of HKFRS 7 for full disclosure requirements of financial instruments.

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