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

Alert

Updates on financial reporting and auditing

Issue 13 (January 2011)

Dear members,

2010 report on practice reviews of practices with listed clients

By the end of 2009, six months ahead of our committed three-year target, the quality assurance department of the Institute 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. Big Four practices are reviewed annually due to the size and significant public interest element of their client base.

Reviews statistics and results

In 2010, the quality assurance department reviewed 20 practices with listed clients, including the Big Four and submitted 19 initial practice review reports to the practice review committee for consideration. Seven reviews, including the Big Four, were directly closed and 12 reviews required follow-up actions. Among these 12 reviews, seven of the practices were requested to prepare remedial action plans and follow-up status reports to address the findings identified in practice reviews and five practices will be subject to a follow-up review in 2011.

Five practices with listed clients received a follow-up review in 2010. Two reviews were still in progress at the end of the year. The other three follow-up review cases that were submitted to the practice review committee for consideration resulted in either requests to provide additional information for the committee's further consideration or another follow-up review.

In addition, the quality assurance department received and evaluated 18 remedial action plans and follow-up status reports from practices with listed clients that provided information on their progress in addressing findings identified in practice reviews carried out in 2008 or 2009. The practice review committee considered and agreed with the quality assurance department's assessment of these submissions, concluded that in 17 cases the outcome was satisfactory and one practice will be subject to follow-up review in 2011.

Review findings and recommendations

The following is a summary of findings and recommendations from the reviews.

Monitoring

All the practices with listed clients under review in 2010 had implemented monitoring policies and procedures. However, some practices' documentation to evidence monitoring reviews was insufficient. Practices are reminded to document clearly the scope of review, review procedures, results and findings and follow-up actions. This documentation requirement applies to reviews of both quality control procedures and completed audit engagements. Clear documentation of findings from reviews and remedial actions can assist practices to address identified weaknesses and monitor progress on rectifying them.

Independence – fees and long association of senior personnel with audit clients

For smaller practices with one or few listed clients, it is common that audit fees from listed clients form a significant portion of a practice's total revenue. This may create a threat to independence. Practices are reminded that the revised Code of Ethics for Professional Accountants provides that if the total fees from a listed client and its related entities represent more than 15 percent of the total fees received by the practice for two consecutive years, the practice shall 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.

To reduce familiarity and self-interest threats to an acceptable level, the code requires that key audit partners, including the engagement partner and engagement quality control reviewer, of a listed client are rotated after seven years and key audit partners shall not be a member of the engagement team for two years following rotation. In practical terms, a practice with less than three (or even four) partners could find it very difficult to serve a listed client over the longer term. Therefore, practices are advised to consider the above rotation requirements from the very start of a client relationship.

Acceptance and continuance

Not all practices appear to fully understand the demands that listed audit clients place on the practice's audit processes and procedures, resources and independence. When making acceptance or continuance decisions, practices are advised to carefully consider the following:

(a) Is the practice competent to perform the engagement and does it have the capabilities, including time and resources, to do so? There is a higher chance that listed clients will be involved in more complex transactions and listed clients are required to comply with more regulations or requirements. Some practices underestimate the technical knowledge and resources required in carrying out listed company audits.

(b) Can the practice comply with relevant ethical requirements? As mentioned above, practices are required to observe independence rules and should carefully assess how to comply with those requirements before accepting a listed audit client.

(c) Does the practice understand the engagement risks attached with listed clients? Practices are reminded to exercise extra caution when accepting a client where there has been a qualified audit opinion or a regular change of auditor as such circumstances could be indicative of potential engagement risks. Moreover, practices should obtain professional clearance from outgoing auditors before accepting the new appointment so that sufficient information is available for the practice to assess the engagement risk level. If a practice does not receive clearance from outgoing auditors, the practice needs to assess whether that is indicative of issues or risks that might cause the practice not to accept the audit. Practices should also request management to provide a copy of the outgoing auditors' letter setting out the circumstances leading to their resignation or termination.

Practices are also reminded to document the assessments made to support the acceptance or continuance decisions made.

Accounting treatment of and audit work on complex transactions

Listed entities are often involved in complex business transactions and significant accounting issues, e.g., business combinations, recognition and impairment of intangible assets and goodwill, issuance and accounting for financial instruments, valuation of assets and revenue recognition. In some cases, the quality assurance department reviewers would challenge the sufficiency of audit work by practices on these types of transactions. Questions were raised where there was no or insufficient evidence in audit files to demonstrate that the auditors had a thorough understanding of complex client transactions and had made a proper evaluation of the appropriateness of accounting treatments adopted by their clients. Practices are reminded that they should obtain a clear understanding of the business rationale of significant transactions and plan appropriate audit procedures. Critical evaluations should be made of client's financial reporting and if necessary, practices may need to challenge client's treatment or judgment. Audit work performed on significant transactions should be documented in working papers to support the conclusions and audit opinion.

Communication with those charged with governance

Effective two-way communication between the auditor and those charged with governance is important in assisting the auditor to obtain information relevant to the audit and those charged with governance in fulfilling their responsibility to oversee the financial reporting process. Significant findings from the audit such as significant business transactions as discussed above were often not communicated with those charged with governance, e.g., the audit committee, or no documentation was in the audit file to evidence that communication with audit committee had been made. Where matters are communicated orally, the practices should record the nature of the matter, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor should retain a copy of the communication as part of the audit documentation.

Information technology controls and reliance on IT generated reports

It is common that a listed entity's financial reporting system makes extensive use of IT. Some practices did not have a clear understanding of the listed client's IT system and had not tested general IT controls. It was also observed that in some cases practices rely on certain IT generated reports without checking the accuracy and completeness of such reports. Practices should plan and perform audit procedures on the financial reporting system, including IT system. General IT controls and application controls should be tested when they have a significant impact on financial reporting. Practices should obtain evidence about the accuracy and completeness of IT generated reports and test for relevant IT controls over the report generation process if they have to rely on such reports.

Group audits

A listed client audit usually is a group audit and sometimes may involve the use of component auditors. The quality assurance department reviewers noted that some practices relied on component auditors' work without clearly assessing the component auditor's competence and appropriateness and sufficiency of audit work. In some instances the only work done by the group auditor was to obtain the component financial information and an audit questionnaire from the component auditors. HKSA 220 *Quality Control for an Audit of Financial Statements* stipulates that the group engagement partner is required to be satisfied that the component auditors have the appropriate competence and capabilities. The group engagement partner is also responsible for the direction, supervision and performance of the group audit engagement. Practices are recommended to refer to the new HKSA 600 *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)* which assists the group engagement partner to meet the requirements of HKSA 220 where component auditors perform work on the financial information of components.

Changes in 2011 – increase in frequency of reviews

Given the fact that there are practices other than the Big Four that now have quite significant numbers of listed audit clients, the practice review committee has decided to increase the frequency of reviews of practices with significant number of listed clients. This is the Institute's commitment to address areas of higher public interest. There is no change to the current programme of annual review of each of the Big Four. Other practices with more than 20 listed clients will, in addition to the current arrangement of one full review at least every three years, receive an additional interim review during the three-year cycle. Interim reviews will focus on key changes in systems and procedures, action taken following the previous practice review, current auditing and accounting issues, and review of completed listed client audit engagements. This will be effective for the 2011 review programme.

Conclusion

As most practices have been reviewed at least once in the first review cycle, we expect the current review cycle will see an improved levels of compliance with professional standards. High quality financial reporting and auditing are important for Hong Kong to maintain its position and reputation as a world class capital market. Practice review of auditors of listed companies must be, and must be seen to be, rigorous and effective. To this end the practice review committee will utilize the powers available to it under the Professional Accountants Ordinance which extend to referring practices to the Institute's disciplinary process.

In addition to fulfilling its regulatory responsibilities, the Institute is committed to assist members and practices to carry out their professional work to the highest standards. The practice review programme can help achieve this. Information and comments received during the reviews are used to develop training and support activities to equip members to improve their levels of understanding and compliance with professional standards.

Sincere regards,
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Hong Kong Institute of Certified Public Accountants
CPA: *The Success Ingredient*