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

Alert
Updates on financial reporting and auditing

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Dear members,

Alert on professional scepticism and audit of mainland companies

2010 and 2011 saw regulators and other parties around the world scrutinizing and opining on the conduct of auditors during the financial crisis of 2008-09. In reports by audit regulators from the U.S., the U.K. and Australia, in the European Commission green paper and subsequent draft legislation and in the report of the House of Lords enquiry in the U.K. there has been explicit criticism that auditors failed to exercise sufficient professional skepticism. In the immediate aftermath of the global financial crisis there was no suggestion that auditors were to blame but subsequently a more critical view has been developed around the role of audit – both in relation to the financial crisis and how audit should develop in the future.

In the glossary of terms to the Clarified HKSAs professional skepticism is explained as *an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence*. It is an attribute that is developed through experience and nurturing within a strong professional and ethical environment. The need for professional skepticism in all stages of an audit has been stressed in the Clarified HKSAs (HKSA 200 *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing,* paragraphs 15 and A18-A22) and has been promoted by the Institute through quality assurance forums and the practice review programme.

With financial reporting requiring significant management judgment in critical areas such as impairment assessment, valuations and going concern it is important that auditors are able and prepared to challenge assumptions made and judgments reached in the preparation of a company's financial statements. Professional skepticism does not mean that the auditor should mistrust all information and representations provided by management and to take this approach would create a very difficult working relationship. However, a belief in the honesty and integrity of management does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence.

The continued importance of auditors applying professional skepticism, especially to the area of going concern assessment and disclosure, has been emphasized in a recent communication from the International Auditing and Assurance Standards Board.

When carrying out practice reviews our reviewers consider whether an appropriate level of skepticism has been maintained by auditors and are prepared to challenge the judgments and conclusion of auditors.

During 2011 there was also a lot of press coverage suggesting that standards of corporate governance and reporting in mainland companies may not be of the highest standard. Much of this has originated from the U.S. where regulators and investor groups have expressed concern over accounting issues in mainland companies listed on North American stock exchanges. Many of the companies named have listed through reverse takeover schemes rather than the more traditional route of IPO.

U.S. regulators have been critical of the work undertaken by auditors of these companies (PCAOB Research Note # 2011 – P1). Although PCAOB criticism has been directed primarily at U.S. based audit firms it is of relevance to many of our member firms given the amount of audit business that is generated by mainland companies or Hong Kong companies with significant operations in the mainland. Hong Kong auditors will often rely on work done by mainland auditors in reaching their opinion on the financial statements of their client companies or groups. Hong Kong auditors are far better placed than their U.S. counterparts to carry out an effective audit of mainland companies or operations as a result of being less distanced by language differences and more alert to cultural and business practices in the mainland. However, there is no room for complacency and Hong Kong auditors should be alert to specific audit risks that may be found in the audit of mainland companies or operations.

The Institute annual audit conference held in September 2011 included a session on how auditors should be alert to and react to audit issues that may be of particular significance in the audit of Mainland companies and operations. The panel members also urged auditors to make sure that they approached all audits with an appropriate degree of professional skepticism. This alert is being issued as timely reminder of the main points highlighted at the conference and at other events for auditors to consider during the audit peak season.

Third party confirmations

- Audit firms have identified the extraordinary steps some companies will take to falsify evidence provided to auditors. In one example a member of the audit team was taken by a company representative to a bank to obtain a balance confirmation directly from bank staff. When the auditor returned alone to the bank the next day to clarify some of the information provided the bank explained that the individual who had provided the confirmation was not and had never been a member of staff of the bank.
- Ensure all stages of the confirmation process are controlled by the auditor. Do not let the client arrange to send out the confirmation requests or collect the replies.
- For electronic or faxed responses take care to confirm the identity of the sender and that multiple responses have not all been sent from one source.

Existence, ownership and valuation of assets

- Auditors should not accept that inventories maintained at mainland locations are not accessible for verification.
- Ownership of assets in the mainland is subject to different legal rules and frameworks than those that may be familiar to a Hong Kong audit firm. The auditor needs to be sure that ownership of assets such as property and mineral rights is fully understood and properly confirmed.

- Where valuations of assets or impairment assessments are provided by valuers appointed by company management auditors need to be sure that they are able to understand the experience and authority of the valuer as well as the methodology employed in the valuation. (HKSA 500 *Audit Evidence* paragraphs 8 and A34-A48.)

Reliance on local auditors for audits of components

- If Hong Kong auditors plan to rely on the work of mainland auditors regarding key subsidiaries or operations they must be alert to the requirements of HKSA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors).*
- HKSA 600 is a significant improvement from the previous standard for group audits and introduces a number of specific requirements that must be complied with by the group auditor.
- The nature and content of communication with component auditors is specified in HKSA 600 (paragraphs 40-41 and A57-60) and group auditors are required to understand not just their client but also the component auditor (paragraphs 19-20 and A32-A41).
- The group auditor cannot divest any responsibility for the group audit opinion.

All of the issues highlighted should be considered by auditors before starting audits. Practice review will continue to look at how auditors have applied professional skepticism and addressed audit risks. The above referenced standards and other documents are recommended reading and will help Hong Kong auditors continue to provide quality audit services to their clients and maintain the reputation of the Hong Kong audit profession.

Sincere regards,

Chris Joy
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