QUALITY ASSURANCE

Striving for sustainable audit quality

2020 Annual Report

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

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Foreword

2020 was yet another eventful year for Hong Kong. COVID-19 caused significant disruption to all our lives, the operations of practice units, and also to our practice review work. Since early in 2020, we replaced many onsite practice review visits with desktop reviews in the Institute's office. Even with the disruption, we still managed to carry out some onsite visits, focusing on larger practices, during the periods when COVID-19 cases dropped to a low level and restrictions were eased. This report sets out the work achievement and outcomes under our practice review and professional standards monitoring programmes as well as common findings.

This is the first full year after the transfer of responsibilities for the reviews of listed engagements from the Institute to the Financial Reporting Council (FRC). During the year, the Quality Assurance Department (QAD) completed all outstanding practice review cases involving listed engagements and moved its focus onto reviewing unlisted engagements as well as anti-money laundering and counter-terrorist financing (AML/CTF) compliance. We managed to allocate resources previously used in reviews of listed engagements to significantly increase the number of reviews carried out on practice units from 354 to 431.

In 2020, the number and proportion of direct closed cases increased from previous years. Nonetheless, 14 review cases, including 9 first time review cases, resulted in a complaint being raised and one review case resulted in a referral to the FRC. These results show that our practice review programme has a valuable role to play to improve the general level of and safeguard audit quality.

In late 2020, we received the Mainland audit working papers of two trial cases under temporary license arrangements from the Chinese Ministry of Finance (MoF) that assisted the relevant practices to go through the vetting procedures necessary to take files located in the Mainland to Hong Kong for our review. Once we have completed the reviews of those working papers, we will proceed to find out more about the vetting procedures before establishing a formal cooperation arrangement. We thank the MoF for their efforts made in coordination with other relevant Chinese authorities in order to break through the access issues that have existed for some time.

Throughout the year the QAD took further steps to enhance our risk-based supervisory programme of AML/CTF compliance to follow up on the Financial Action Task Force's recommendations made in its 2019 mutual evaluation report on Hong Kong. These included issuing an alert, an exposure draft, a questionnaire, and undertaking various engagement and educational activities. However our initial proposals have not proceeded as originally planned and the QAD is working to address concerns raised by members. While it is understandable that there are concerns over new regulations, the Institute – being the AML / CTF regulator of the accounting profession – will need to be able to demonstrate that it is properly discharging its duties in order to meet regulatory expectations. The QAD will therefore continue to seek input from various stakeholders to determine the way forward.

Our professional monitoring programme continued to focus on the application of new standards, in particular HKFRS 16 *Leases*, which became effective from 1 January 2019. Although some application and disclosure deficiencies were identified, they were not significant. Given the new standards contain much more guidance as compared to their predecessor standards, we suggest that more specific disclosures of the judgement involved based on own circumstances in the financial statements would help users understand more how the standards are applied. In addition, since COVID-19 has impacted all entities (albeit to different degrees) we recommend that entities include an appropriate level of disclosures of the impact of COVID-19 in their financial statements to increase transparency and predictability of future effects.

Finally, I would like to thank practices for their cooperation during the difficult time of COVID-19. Without their efforts to arrange files be delivered to the Institute for our review, we would not have been able to achieve as much as we managed during 2020.

Elsa Ho
Director, Quality Assurance
March 2021

Oversight of our work

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

The responsibility for oversight of QAD activities rests with the Regulatory Oversight Board ("ROB") which oversees all the regulatory functions of the Institute.

The ROB ensures that QAD activities are carried out in accordance with strategies and policies determined by the Council of the Institute and in the public interest. The ROB receives and reviews annual work plans and budgets and regular progress reports from management and annual process review reports on the implementation and effectiveness of the practice review programme carried out by the QAD from the Practice Review Committee; and reports to the Council observations and views in relation to performance and operations. Please refer to Annex for members of the ROB.

Our work and review outcomes – Practice review programme

Practice review is a quality assurance programme that monitors all practice units registered by the Institute, including individual practising certificate holders, firms and corporate practices, to determine whether they have observed, maintained and applied professional standards. The Professional Accountants Ordinance ("PAO") has empowered the Institute to carry out practice review since 1992. The approach to practice review is regularly amended to maintain best practice, in particular Statement of Member Obligation 1 *Quality Assurance* issued by the International Federation of Accountants of which the Institute is a member.

The Institute's practice review programme consists of two elements: the audit quality assurance reviews and the Anti-Money Laundering and Counter-Terrorist Financing ("AML / CTF") Compliance Monitoring Reviews ("ACMRs"). The purpose of the audit quality assurance reviews is to determine whether practices have observed, maintained and applied professional standards, including all the statements and guidelines of professional ethics, financial reporting standards and standards on auditing and assurance. The purpose of ACMRs, which were introduced in October 2018 within the Institute's practice review programme, is to monitor the level of compliance of the Institute's practice units with the Guidelines on AML/ CTF for Professional Accountants ("AML Guidelines") included as part of the Institute's Code of Ethics and the amended Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("AMLO").

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

Process

The process of a practice review (including an ACMR) or a separate ACMR can be divided into three stages:

Stage 1 – Preparation

- Select practice for review
- Agree on visit date and request key documents
- Preliminary assessment of submitted key documents including, if applicable, the completed audit health screening checklist and the self evaluation checklist

Stage 2 – On-site visit / inhouse desktop review

- Opening meeting*
- Conduct interviews*
- Review compliance with HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* and selected audit files (not applicable to a separate ACMR)
- Review compliance with AML Guidelines and selected customer due diligence ("CDD") documents, if applicable
- Summarize findings and recommendations
- Exit meeting*

** These procedures are usually carried out by telephone for desktop reviews*

Stage 3 – Reporting

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

Practice selection

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

On 1 October 2019, the Financial Reporting Council (Amendment) Ordinance ("FRC(A)O") took effect, giving the Financial Reporting Council ("FRC") responsibilities to regulate auditors of listed companies in Hong Kong. Since then, the FRC has taken on the responsibilities for inspection of PIE engagements completed by PIE auditors on or after 1 October 2019. The Institute's practice review programme continues to cover all active practices but its remit has changed to regulation of non-PIE engagements and AML/CTF compliance.

The Institute continues to apply a mixed risk-based-cycle approach for selection of practices for reviews. Within that approach, the Institute has a goal to review all active practices at least every 6 years. The frequency of practice reviews of practices with audit and assurance clients ("AA clients") will be determined based on the following factors:

1. Size – based on the number of non-PIE AA clients[Note] and practising partners or directors

2. Complexity – based on the number of regulated non-PIE AA clients [Note].

Note:

Non-PIE AA clients are AA clients whose engagements fall outside the definition of PIE engagements specified in FRC(A)O and therefore are included in the scope of the Institute's practice review programme. Non PIE-AA clients included in the following categories are considered regulated non-PIE AA clients for the above purpose:

a. "authorized institutions" as defined under the Banking Ordinance

b. "insurers" as defined under the Insurance Ordinance

c. "insurance brokers" as defined under the Insurance Ordinance

d. "licensed corporations" and "associated entities" as defined under the Securities and Futures Ordinance

Based on these factors, all active practices with AA clients are separated into categories with appropriate frequencies of practice reviews as follows:

	Practices	Frequency of review
Standard	With 500 or fewer non-PIE AA clients and with 10 or fewer regulated non-PIE AA clients	6 year cycle (a goal to achieve)
Tier 1	With more than (i) 500 non-PIE AA clients or (ii) 10 regulated non-PIE AA clients	3 year cycle
Tier 2	With more than (i) 1000 non-PIE AA clients and (ii) 10 regulated non-PIE AA clients	1.5 year cycle
Tier 3	With more than (i) 1000 non-PIE AA clients; (ii) 20 regulated non-PIE AA clients and (iii) 50 practising partners or directors	Annually

Practice reviews of practices without AA clients are subject to separate ACMRs normally on a six-year review cycle basis. ACMRs on these practices will be more frequent if a large proportion of their activities involve specified transactions as defined in the AML Guidelines.

As well as the above factors, other practice-specific information will be considered when determining the review frequency of individual practices. These factors include:

1. Previous regulatory history – based on past practice review results and regulatory actions taken by the Institute and other regulators
2. Other risk factors identified through the Institute's regulatory system
3. A small number of reviews randomly selected every year

Audit quality assurance reviews

The scope of an audit quality assurance review includes obtaining an understanding of the practice's system of quality control, assessing compliance with HKSQC 1 and the practice's policies and procedures, and reviewing completed audit engagements. The extent of review work that the QAD carries out varies from practice to practice depending on the size of the practice and the nature of its client base.

Desktop reviews are carried out for small practices with no predetermined risk factors. Desktop reviews take place at the Institute's office and comprise a review of the latest monitoring report and one audit engagement. An initial self-evaluation process is included as part of the desktop reviews for low risk practices with only a handful of audit clients.

ACMRs

The scope of an ACMR includes obtaining an understanding of the practice's relevant AML/CTF policies and procedures and inspecting documentary evidence to assess level of compliance with the AML Guidelines and relevant laws and regulations.

There are two types of ACMR, namely a full-scope ACMR and a desktop ACMR. Practices which have prepared for or carried out for clients transactions specified in Paragraphs 600.2.1 and 600.2.2 of the AML Guidelines ("Specified Transactions") will be subject to a full scope ACMR. Other active practices will be subject to a desktop ACMR.

In order to make best use of resources and to cause less disturbance to practices, an ACMR has been included within every full scope and desktop practice review carried out on a practice with AA clients since October 2018 and April 2019, respectively. Separate ACMRs are arranged for practices without AA clients. Full scope separate ACMRs are carried out on site whereas desktop separate ACMRs take place in the Institute's office.

In response to the recommendations made by the Financial Action Task Force ("FATF") in its mutual evaluation report on Hong Kong, the Institute has plans to enhance the risk-based supervisory programme of AML / CTF compliance. Please refer to the section on Risk-based Supervisory Programme of AML / CTF Compliance for further details.

Reporting

The QAD is responsible for drawing conclusions and making recommendations to the PRC for consideration and decisions. The PRC having regard to the report and any response by the practice to the matters raised in the report may act under the power given by the PAO, to:

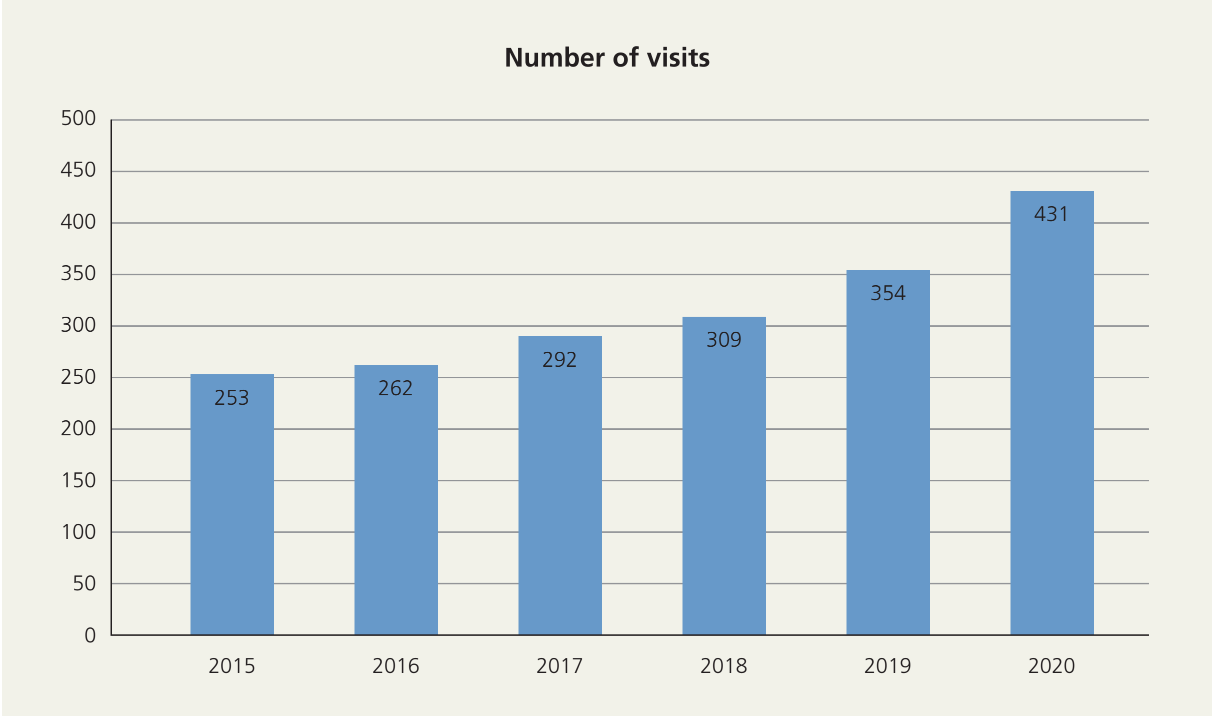
- conclude a practice review with no follow up action required ("direct closed");
- make recommendations and specific requests to a practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings ("required follow up action");
- instruct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

The PRC may also, via the Council of the Institute, make a referral to the FRC if an auditing, reporting and relevant irregularity is identified in a PIE engagement or a component of a PIE engagement.

Each practice is sent a formal notification of the PRC decision. The QAD monitors the progress of actions undertaken by practices at the direction of the PRC.

Our review outcomes

The number of practice reviews carried out each year has increased from 253 in 2015 to 431 in 2020. The increase was mainly due to the reallocation of the resources saved from not having to review PIE engagements after the transfer of the relevant review responsibilities to the FRC.



In 2020, ACMRs were included within all the practice reviews above. In addition, separate ACMRs were conducted on 32 active practices without audit and assurance clients.

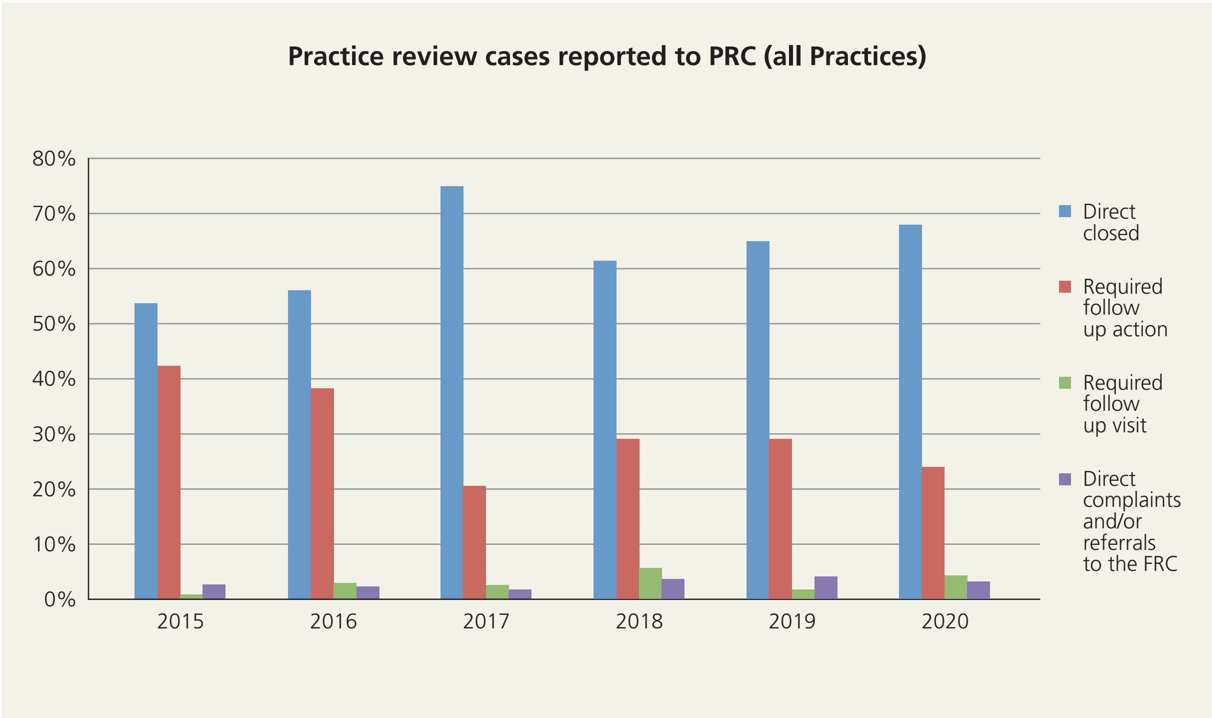
Work progress in 2020

The PRC met on ten occasions in 2020 and considered 425 practice review reports and 31 separate ACMR reports.

The PRC concluded that 285 initial visits should be closed without requiring any follow up actions. For 98 initial visits, practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Eighteen reviews required a follow up visit to assess the effectiveness of remedial actions taken. Fourteen reviews resulted in complaints being raised. One review resulted in a referral to the FRC.

Ten follow up visits were reported to the PRC in 2020. Three follow up visits were closed on the basis that adequate remedial actions had been taken, five required further follow up actions, one required another follow up visit due to a change in directorship during the period under review and one resulted in a complaint.

The review outcomes improved slightly in 2020. 68% of the reviews of practices were directly closed in 2020, representing an increase of 3% from 2019. The reviews that required follow up action have decreased from 29% in 2019 to 24% in 2020. The changes reflect that practices are generally responsive to practice review findings.



In 2020, the PRC decided to raise complaints against four practices with listed clients due to significant audit deficiencies, including failings to obtain sufficient evidence or perform sufficient appropriate audit work on significant items / issues, e.g. impairment assessment, recognition and valuation of unlisted investments, expected credit loss assessment, and going concern evaluation.

In addition, significant findings from a listed entity audit of another practice based on the review taken place in the previous year were referred to the FRC for further investigation in 2020. In this case, the auditor did not adequately assess the client's accounting treatment of product development costs and technical knowhow.

Where findings identified in a first time review amount to serious professional misconduct, the PRC may decide to make a complaint against the practising member(s) which may ultimately result in disciplinary action. In May 2019, the QAD issued Alert Issue No. 29 "Initiatives and measures to strengthen actions to deal with non-compliance" to draw again attention to some of the matters which the PRC will take into account when determining whether the non-compliance matters identified warrant a complaint being raised even on a first time review. Those non-compliance matters included failure to take proactive actions to avoid the Top 5 findings (including no or insufficient quality control policies and procedures; no or ineffective monitoring; unsatisfactory subcontracting arrangements; inappropriate audit methodology; and misuse of modified opinion) from occurring in their practices; adding and creating working papers and false information; and failure to cooperate in the practice review process.

In 2020, nine first time reviews of the Standard category of practices resulted in complaints being raised by the PRC. All these reviews identified matters that showed issues about the professional conduct, competence and/or integrity of the practitioner of the practice (e.g. having fabricated work papers, issued a compliance report without carrying out any work, or provided false information / representation to practice reviewers).

Moreover, one complaint was raised by the PRC against the practitioner of the practice for matters identified in the review that was not a first time review. The results of the review show that this practice failed to comply with directions of the PRC to address the deficiencies previously identified to improve audit quality.

For complaints based on unsatisfactory practice review results, recently completed disciplinary cases show that disciplinary committees are prepared to cancel a member's practising certificate for up to two years. Practices should bear in mind the serious consequences that may result from a complaint being raised by the PRC.

Our work and review outcomes – Professional standards monitoring programme

The programme is a non-statutory financial statements review programme set up in 1988 with the objective to enhance the quality of financial reporting and the application of professional standards in Hong Kong. It is regarded as a useful programme to help understanding of professional standards and assess post-implementation issues.

If there are any matters found in the reviews that indicate possible non-compliance with professional standards, enquiry letters will be issued to members (primarily auditors of the listed companies) requesting explanations of the issues identified. Matters raised primarily focus on financial reporting but the QAD also looks into audit if significant issues are identified. The QAD determines if follow up actions are required on the issues raised with the auditors based on the reviews of the auditors' replies to our enquiry letters. Follow up actions include issuing further enquiry letters and letters with comments to advise members of areas for future improvement. If the issues identified indicate significant potential non-compliance with professional standards that constitutes a "Relevant Irregularity" or "Relevant Non-compliance" as defined under the Financial Reporting Council Ordinance, the financial statements, and our concerns, will be referred to the FRC for investigation.

Changes are often made to subsequent financial statements in light of our comment letters. In order to ensure that members benefit from our programme so as to enhance the quality of financial reporting in Hong Kong, the QAD communicates significant or common weaknesses identified from the reviews to members through different channels including the QAD forums and annual reports.

The programme is supported by the Professional Standards Monitoring Expert Panel ("Expert Panel") and independent external reviewers ("Independent Reviewers"). The Expert Panel is an advisory panel that gives advice to the QAD on the appropriate course of action on significant, complex or controversial issues. The Expert Panel in 2020 comprised representatives from the Big Four firms, medium-sized practising firms and Hong Kong Exchanges and Clearing Limited ("HKEX"). Please refer to Annex for composition of the Expert Panel and Independent Reviewers.

The Independent Reviewers as well as the QAD are involved in conducting initial reviews of financial statements. The QAD assesses the observations identified from initial reviews and determines whether an enquiry should be raised.

The Institute regularly communicates with the FRC and the HKEX which have similar financial reporting review programmes to avoid duplication of reviews.

Our work

The review process comprises three stages:

Stage 1 – Initial review

- Published financial statements initially reviewed by the QAD and Independent Reviewers

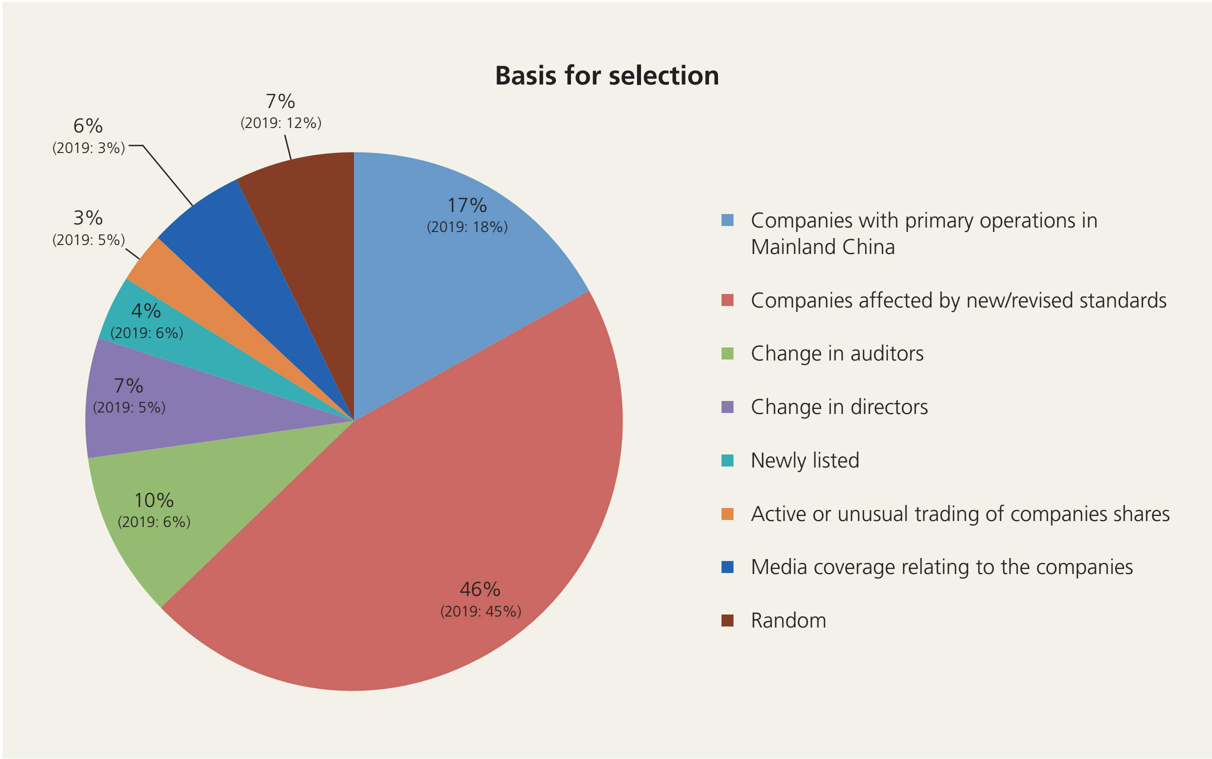
Stage 2 – QAD review

- The QAD reviews observations identified in initial reviews and issues enquiry letters to members when necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

Stage 3 – Follow up

- In cases where enquiry letters are issued, the QAD reviews reply letters from members and decides whether a further enquiry or other appropriate action is necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

The programme uses a risk-based approach to select financial statements for review. The following chart shows the basis of selection of financial statements reviewed in 2020.



Review of initial application of new financial reporting standards is a focus of our programme. In 2020 reviews, initial application of HKFRS 16 *Leases* was our focus of review. Please see "Our findings – Professional standards monitoring programme" for the issues identified from the initial application of HKFRS 16.

Our review outcomes

In 2020, the QAD reviewed a total of 70 sets of financial statements and followed up 9 cases brought forward from the previous year. Although follow up action was not needed for the majority of financial statements reviewed in 2020, issues were identified in some financial statements which warranted issuance of enquiry letters or letters with comments on presentation and disclosures. Please refer to "Our findings – Professional standards monitoring programme" for more information of those issues.

Referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. No cases were referred to the FRC in 2020.

Our findings

Practice review programme

This is the fourteenth annual report on our practice review programme. Following on from the enactment of the Financial Reporting Council (Amendment) Ordinance effective from 1 October 2019, the remit of our practice review programme has changed to regulation of non-public interest entity ("PIE") engagements and AML / CTF compliance. In 2020, we completed all the reviews of PIE engagements completed by practices before 1 October 2019, apart from a small number of cases where arrangements had been made with the Mainland Ministry of Finance regarding related Mainland working papers and case referrals. This report outlines the more common findings and areas of improvement identified from our inspections of 425 practices undertaken in 2020, comprising 288 onsite and 137 desktop reviews, including 10 follow-up visits. To be clear, it is not that all these findings arise in all practice reviews but rather these findings recur more frequently and therefore it is worthwhile communicating them for practices' particular attention. To avoid doubt, we describe the more common findings and areas of improvements as examples.

We separate the content below under the following components of practice reviews.

In Part I, we cover common findings from **firm level inspections** on areas, including (1) engagement management and human resources, (2) acceptance and continuance, (3) file assembly, and (4) professional ethics. In Part II, we draw members' particular attention to key findings from **engagement inspections**, including those concerning: (1) audits of entities that adopted the Small and Medium-sized Entity Financial Reporting Framework ("SME-FRS"), (2) audits of regulated entities, (3) significant accounting and auditing estimates and judgements, and (4) application of Hong Kong Financial Reporting Standard (HKFRS) 9 (2014) *Financial Instruments*, HKFRS 15 *Revenue from Contracts with Customers* and HKFRS 16 *Leases*, and COVID-19 impacts. Our expectations are included at the end of this section.

Part I: Firm level inspections

A system of quality control involves a practice's organizational structure and the policies and procedures in place to support audit quality. The table below shows four common areas where failings to meet the relevant professional standards were identified.

Area	Relevant standards
1 Engagement management and human resources	• HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* • HKSA 220 *Quality Control for an Audit of Financial Statements*
2 Acceptance and continuance	• HKSQC 1
3 File assembly	• HKSQC 1 • HKSA 230 Audit Documentation
4 Professional ethics	• HKSQC 1 • Code of Ethics for Professional Accountants

Apart from the above, we also set out other quality control issues at the end of Part I.

1) Engagement management and human resources

Practices should have a system of control that emphasizes the following elements to ensure professional, high quality audit services are delivered:

- A strong internal culture that encourages quality audits and sound application of professional scepticism;
- Adequate resources including staff with sufficient time and appropriate competence and capabilities to carry out audits; and
- Effective supervision and reviews, including adequate two-way communication between engagement partners and audit team members when planning and executing audits.

Examples of findings

In our inspections, we identified the following that indicated issues on engagement management and human resource adequacy:

- Practices did not evaluate nor take steps to address sufficiency of resources despite taking up an increasing number of audit engagements. Where practitioners had a large portfolio with many clients having the same financial reporting deadlines, questions would arise whether audit quality could have been compromised by matters such as pressure from clients to meet the reporting deadlines.
- Practitioners did not adequately supervise the audit process of the engagements nor effectively carry out file reviews, resulting in many engagement deficiencies being identified. If the time charged by engagement partners over total engagement hours was minimal, it would give an indication that their time involvement in engagements was not sufficient.

- Practitioners and audit staff members did not have sufficient and relevant experience nor receive training on relevant requirements before undertaking compliance work on regulated client engagements.
- Practices were over-reliant on subcontractors who were not their staff or a member of their network firm's staff and did not exercise adequate control over the audit work performed by subcontractors nor take steps to ensure that subcontractors were competent and up-to-date on professional standards when handling assigned audit work.

Improving engagement management

The following are some actions that may help avoid the above issues:

- Monitor and take steps to alleviate practitioners' workloads e.g. reduction in the size of the practices' client portfolio to a reasonable level, recruitment of more audit staff, and/or admission of additional practitioner(s).
- Arrange training and updates for audit teams to ensure they are competent to appropriately handle audits of regulated clients or clients with complicated transactions.
- Increase practitioners' and managers' time spent on engagements, and enhance supervision and review at key stages of an audit, including planning, execution and completion.
- Proper engagement management to address issues early and to minimize deadline pressures at the conclusion of the audit.

2) Acceptance and continuance

To meet the requirements of HKSQC 1, practices should have policies and procedures in place to help them make appropriate acceptance and continuance decisions. Practices should only accept or continue an engagement if they are satisfied about the integrity of the client and that they are competent to perform the services required and comply with ethical standards. The audit team should undertake appropriate assessments, document client acceptance or continuance consideration, and complete standard audit procedures during the planning stage of the engagement.

Examples of findings

In our inspections, we identified the following that indicated issues with the acceptance and continuance of engagements:

- Lack of robust assessment of matters giving rise to independence threats, competence and resources needed, and client integrity during the client acceptance or continuance process.
- Client acceptance or continuance forms were undated or not approved by practitioners prior to the commencement of engagements.
- Practices accepted appointment as auditors before completion of client acceptance procedures. For instance, requests for professional clearance were arranged after the approval of acceptance and issuance of engagement letters.
- Practices did not follow up non-replied professional clearance requests nor assess the implication of not receiving professional clearance before accepting a new client.

- No documented consideration of the matters which gave rise to the prior year's modifications of the audit opinion and the actions taken to address or resolve them before the next audit. Paragraph 400.52 of the Code of Ethics provides that, in deciding whether to accept appointment or reappointment as auditor, the practice should consider whether the envisaged limitation imposed by the client is so significant that the need to issue a qualification of opinion exists and if so, the practice would normally not accept appointment or reappointment as auditor.

Client acceptance and continuance considerations

As part of the acceptance or continuance exercise, practices should carefully consider the following matters:

- Has professional clearance been obtained from the previous auditor, and are there any professional or other reasons for not accepting the appointment or reappointment?
- Are there independence threats that require safeguards to be applied?
- Do practitioners and staff have the competencies needed to perform the engagements?
- Have there been risks of material misstatement due to fraud?
- Are there complex accounting issues e.g. asset valuations that require special expertise to deal with, or prior year modifications to the audit opinion to consider?
- Is there a need for external consultation or an engagement quality control review?
- Are there going concern issues?
- If it is a group audit, are there matters that require special considerations under HKSA 600 Special Considerations – *Audits of Group Financial Statements (Including the Work of Component Auditors)*?

To assist with this process, it is recommended that practices use standard checklists and templates (e.g. the assurance engagement acceptance/continuance form from the Institute's A Guide to Quality Control) to ensure consistent application of the acceptance and continuance considerations.

3) File assembly

Completion and retention of audit engagement documentation should meet the standards required by HKSQC 1 and HKSA 230. Practices are required to complete the assembly of the audit files on a timely basis, which should not normally be later than 60 days from the date of the audit report. The date of final assembly should be shown clearly on the file once assembly has been completed. Audit files should be retained for at least five years from the date of the audit report.

Examples of findings

In our inspections, we identified the following that indicated issues with file assembly:

- No policies and procedures to require audit teams to (1) complete the assembly of final engagement files (paper and/or electronic) on a timely basis after the audit reports had been finalized, and (2) ensure that the final version of audit work papers was retained on file.
- Incomplete archiving of audit work papers. As a result, some work papers and documents were not retained in the archived audit files.

- No controls to ensure that archived files were not subsequently modified.
- No record of the completion date of file assembly to evidence compliance.
- No controls over confidentiality, safe custody, accessibility and retrievability of audit files for practices sharing offices with other third parties or practices that had subcontracted work to others.

File assembly procedures

Practices are reminded that file assembly procedures are administrative procedures to compile all the documented evidence together in a sensible order. The following procedures are not file assembly procedures and should be completed before the audit report date:

- Review of working papers;
- Obtaining audit evidence;
- Planning and completion procedures to comply with standards; or
- Performance of audit work.

After assembly, the audit file should be kept in a secure place with restricted access for the duration of the retention period as determined by the firm's quality control policies and procedures.

4) *Professional ethics*

4.1) Auditor's independence

According to the Code of Ethics, there are five major threats that may compromise an auditor's independence, i.e. self-interest threat, self-review threat, advocacy threat, familiarity threat and intimidation threat. Before an audit engagement, it is crucial that all potential threats to independence are considered and assessed. If a significant independence threat is identified, safeguards should be developed and implemented to reduce the threat to an acceptable level. If no adequate safeguard can be applied, the practice should decline or resign from the audit engagement.

Examples of findings

In our inspections, we identified the following that indicated independence issues were not appropriately addressed by practices:

- No documentation of the evaluation of the threats to independence arising from the provision of non-assurance services to an audit client by the practice or its affiliated service companies and no appropriate safeguards in place to mitigate the threats.
- Failure to assess the significance of self-interest or intimidation threats due to relative sizes of audit and non-audit fees that represented a significant portion of the practice's total revenue.
- Clients referred by service companies contributed significantly to the total revenue of the practice. No consideration was given to the potential independence threats created by business relationships with the service companies and safeguards required.

- Referral fees were paid to another professional accountant for referral of audit clients, but no safeguards were applied to address such a self-interest threat. Paragraphs 330.5 A1 to 330.5 A2 in Chapter A of the Code of Ethics set out examples of safeguards, including disclosure to the clients any referral fees paid in such circumstances.
- An audit team member was the key management of an audit client. Despite this close business relationship, the practice did not take actions to eliminate the self-interest, familiarity or intimidation threats (such as to remove the audit team member from the relevant engagements) as suggested by Section 521.7 A2 in Chapter A of the Code of Ethics.

Independence evaluation

Practices should maintain independence to meet ethical requirements and, when in doubt, take a conservative approach. Practices are expected to:

- Document their assessment of independence threats.
- Put in place adequate safeguards to mitigate these threats.
- Actively monitor the safeguards in place to ensure mitigation is successful.

4.2) Professional conduct

The fundamental principle of integrity under Section 111 of the Code of Ethics imposes an obligation on a practitioner to be straightforward and honest in all professional relationships. According to Section 113 of the Code of Ethics, a practitioner shall maintain professional knowledge and skills at the level required to ensure that clients receive competent professional services and act diligently in accordance with applicable technical and professional standards.

Examples of findings

In our inspections, we identified the following that raised serious concerns over the integrity and professional conduct of the practitioners:

- Fabrication of audit documentation after the audit report date or in response to the practice review, such as (a) adding audit programmes and work papers; (b) replacing audit programmes with other sets; and (c) creating or amending work papers on significant account items. The act of fabrication violates the Code of Ethics and cast serious doubt on the integrity and conduct of the audit team and the practice.
- Deliberate attempts to mislead the practice review teams by making untrue statements during the course of practice reviews.
- Provision of false information in the electronic self-assessment questionnaire and the health screening checklist submitted in relation to practice reviews.
- Intentional under-reporting of audit clients in the client list.
- The audit report dated before completion of audit work.
- No file or work to support the audit or compliance opinion given.
- Misuse of modified opinions to circumvent necessary audit procedures, indicating failure to diligently carry out audits in accordance with professional standards.

Serious professional misconduct

The nature and severity of the above failures demonstrated blatant disregard of the duties and responsibilities of an auditor and the requirements under professional standards and amount to serious professional misconduct. The Practice Review Committee ("PRC") took these failures seriously and has initiated complaints against practitioners under Section 32D(5) of the Professional Accountants Ordinance ("PAO") on the basis of professional misconduct under Section 34(1)(a)(viii) of the PAO. Even when practitioners made early admission of wrongdoing, this could only be considered as mitigation when determining disciplinary actions but did not diminish the seriousness of the breaches. Based on past disciplinary cases, such breaches could result in a **reprimand, penalty, cancellation of the practicing certificate** and/or **an order that the practicing certificate should not be issued** to the practitioner **for a specified period up to three years**. Practices should take note of the above and ensure those situations do not arise, or face the possibility of a complaint being raised by the PRC.

5) Other quality control issues

In our inspections, we identified the following other common quality control issues:

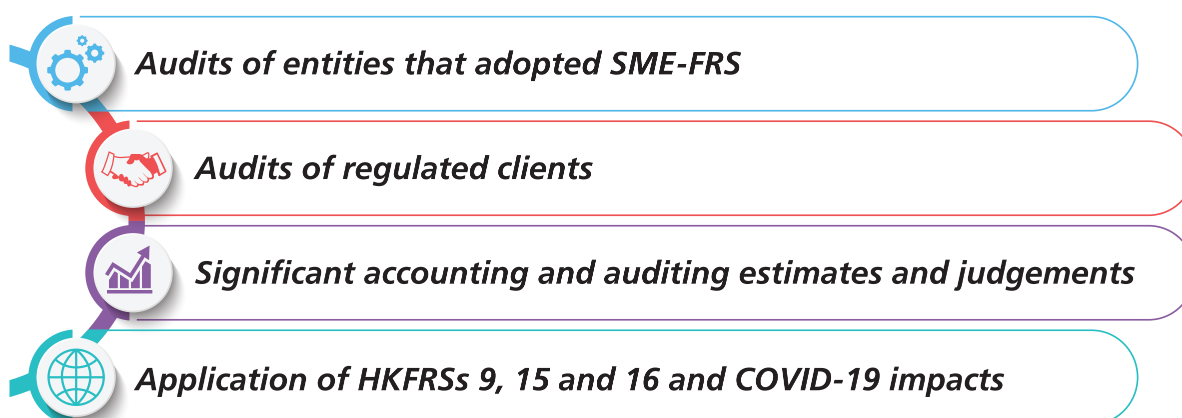
- Monitoring review reports were boilerpate (e.g. same generic findings on all engagements reviewed).
- No follow-up work to address findings identified in monitoring reviews.
- A monitoring review was not performed according to the timeframe required by HKSQC 1, i.e. annually for the quality control system and at least once every three years for completed engagements.

Monitoring

Monitoring is essential to measure the operational effectiveness of the quality control and audit systems. In order to enhance the effectiveness of a monitoring review, practices should entrust a partner or another person with sufficient and appropriate experience and authority to assume the responsibility for the monitoring process. In case a practice intends to use an external monitor, the practice should carefully evaluate and be satisfied with the competence and experience of that monitor before engaging him or her to carry out a monitoring review.

Part II: Engagement inspections

Since the transfer of the review responsibilities of PIE engagements to the Financial Reporting Council from 1 October 2019, our focus of engagement inspections has been on reviewing the quality of non-PIE engagements. From our engagement inspections, we identified the following four common areas that require practices to pay more attention:



1) Audits of entities that adopted SME-FRS

An audit of a SME does not necessarily mean an easier audit and requires work to meet all relevant requirements under auditing standards. Small businesses tend to have particular characteristics that require increased attention, for example, fewer internal controls, and more related party transactions. From the perspective of small and medium sized practices, keeping up with changing requirements and maintaining the required knowledge base can be challenging.

Examples of findings

In our inspections, we identified deficiencies in the audit work performed on SME audits that were primarily related to basic audit requirements across a number of areas. For instance, practices did not:

Audit planning and risk assessment

- provide appropriate justification for the rebuttal of fraud risk in revenue recognition. Practices are reminded that the presumption of fraud risk in revenue recognition may be rebutted, for example, in situations comparable to the example provided in HKSA 240 where there is a single type of simple revenue transactions.
- identify audit risks at assertion and financial statement levels.
- document and evaluate design and implementation of internal controls over major business processes as required by HKSA 315.

Revenue and expenses

- check delivery documents to determine the timing of transfer of risks and rewards of goods purchased and sold.
- carry out adequate audit procedures on contract revenue and costs.
- document sufficient details and extent of the audit work done, such as the items tested, testing coverage, and types of supporting documents inspected.
- determine sample sizes for substantive tests after taking into account the population values, materiality and audit risks identified rather than applying a standard sample size across all tests.
- perform a test of control or a substantive analytical review if such work was planned to be carried out according to the audit plan and update the plan for any subsequent changes.

Assets and liabilities

- perform audit work to assess the recoverability of material receivable balances that remain unsettled before the audit report date.
- perform work to assess reliability of audit confirmations received by either fax or scanned copies.
- perform sufficient alternative audit procedures on trade receivable and payable balances without returned confirmations.
- assess reliability of internally generated documents before using it as audit evidence.
- perform sufficient audit procedures (e.g. audit confirmations concerning banks, debtors and creditors, and sales and purchase cut-off tests) to obtain adequate evidence regarding the opening balances in initial audit engagements.

Group audit

- assess the consistency and appropriateness of the accounting policies applied by significant components; and adequately participate in and assess the adequacy of the component auditors' work.
- document details of the nature, timing and extent of work done in the group audit to support the sufficiency and appropriateness of audit evidence obtained to address significant audit risks.

Audit completion and reporting

- assess the financial capabilities of the shareholders relied on to provide financial support to the client.
- assess the pervasiveness of the effect of a scope limitation or a departure from HKFRSs on financial statements to support the type of modified opinion (i.e. a qualified, adverse or disclaimer of opinion), set out appropriate details of the basis for the modified opinion in the audit report and where applicable, further modify the audit opinion to take account of the matters which gave rise to the prior year's modified opinion that remain unresolved.

The International Auditing and Assurance Standards Board ("IAASB") is developing a separate standard for ***audits of financial statements of less complex entities*** *("LCE") and plans to issue an exposure draft in mid-2021. Its aim is to keep the LCE auditing standard under the current audit framework with the same underlying concepts, including professional judgement and scepticism, clear and consistent documentation, and reasonable assurance opinion; and objectives for auditor's procedures. The new standard will be divided into parts following the flow of an audit and setting out the relevant requirements for the various areas within an audit. The Institute is involved in the development of the new standard and will provide updates to members in due course.*

2) Audits of regulated clients

This part focused on three types of regulated clients, i.e. insurance brokers, solicitors, and owners' corporations of buildings. For **licensed corporations registered with the Securities and Futures Commission**, we encourage practices to take note of key findings published in the 2018 Quality Assurance Report (pages 26-28). In this regard, practices are reminded that the Institute issued PN 820 (Revised) *The Audit of Licensed Corporations and Associated Entities of Intermediaries*, in December 2020. PN 820 (Revised) has put more emphasis on risk assessment and provides additional guidance on how risk assessment should drive the extent of audit work for licensed corporations. More guidance on the use of information technology and various other updates have been added.

2.1) Insurance brokers

The Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules ("Rules") took effect on 23 September 2019. The Rules set out new requirements for licensed insurance brokers in relation to capital and net assets; professional indemnity insurance; keeping of separate client accounts and keeping of proper books and accounts.

PN 810.1 (Revised) *Licensed Insurance Broker Companies – Compliance with Insurance (Financial and Other Requirements for Licensed Insurance Broker Companies) Rules*, provides guidance to practices issuing a compliance report on an insurance broker and sets out recommended procedures and examples of assurance reports in the Appendices. In order to provide limited assurance, practices should obtain sufficient, appropriate evidence in accordance with HKSAE 3000 (Revised) *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*, with reference to PN 810.1 (Revised).

Examples of findings

In our inspections, we found instances where practices did not:

Capital and net assets

- perform compliance work procedures for a minimum of three dates for the purpose of the auditor's reporting on compliance with the minimum requirements of capital and net assets by the insurance broker. These three dates should be the year end and two other dates in the year, and the intervening periods between those dates must not be shorter than three months.
- perform work to assess reliability of the management accounts used to support the insurance broker's net assets.

Professional indemnity insurance ("PII")

- compare the PII coverage with two times the aggregate amount of the insurance brokerage income in the 12 consecutive months immediately before the commencement date of the policy period where the period of PII cover did not coincide with the financial year.
- obtain written evidence (such as bank statements, and correspondence between the insurers and the insurance broker) to check whether there had been any material claims during the year.
- assess whether the deductible amount under the PII policy was not more than 50% of the insurance broker's net assets at the end of the year preceding the commencement date of the PII cover.

Keeping of separate client accounts and proper books and accounts

- select a sample of transactions both from the bank statements and from the ledgers to establish whether those transactions fell within the scope of permitted deposits and withdrawals.
- test the client monies reconciliation statements and relevant supporting documents on a sample basis to determine whether comparison and reconciliation of client monies were properly performed.
- physically inspect a sample of accounting records to ensure that the insurance broker had retained accounting records for at least seven years.

Commission income recognition

- perform work to assess whether the policy placement services and the claims handling services provided for the policyholders were two separate performance obligations in contract under HKFRS 15.
- assess the appropriateness of accounting for variable commission under HKFRS 15, in particular whether it was highly probable that a significant reversal of revenue will not occur by the end of the clawback period.

Practices should take note of the revisions to the requirements as a result of the provisions of the Insurance Companies (Amendment) Ordinance, which are double underlined in the respective parts of PN 810.1 (Revised). In addition, practices should be mindful of the transitional arrangements in paragraphs 50 to 54, which apply to a "specified insurance broker company", i.e. a company which was registered with an approved broker body as a member immediately before the commencement date, and only becomes licensed for the first time under the new regime after the commencement date.

2.2) Solicitors

Rule 4 of the Accountant's Report Rules ("ARR") lays down the duties of practices when issuing an Accountant's Report on a firm of solicitors. PN 840 (Revised) provides guidance on the reporting on solicitor firm's accounts under the Solicitors' Accounts Rules ("SAR") and the ARR. In addition, PN 840 (Revised) appends the following two checklists which practices are expected to follow before issuing an accountant's report:

- Appendix 1 *Key Questions Based on the Solicitors' Accounts Rules* that sets out a list of key questions based upon the SAR, designed to check compliance with obligations of the solicitors' firm regarding client's monies; and
- Appendix 2 *Engagement Programme under Rule 4 of the Accountant's Report Rules* that sets out the audit procedures and steps expected of practices to ensure compliance with the SAR.

Examples of findings

In our inspections, we found instances where practices did not:

Client monies

- test check when client monies were received, entered in the cash book and banked without delay, and consider whether there were indicators of teeming and lading.
- test vouch monies withdrawn from the client bank account, identify the nature and purpose of withdrawals, and check the instructions of the clients.
- check whether non-client monies were paid into the client bank account.
- check no transfers between individual clients in the records had been made other than under the rules relating to lodgement and withdrawal.

Client ledger accounts

- perform compliance work procedures (i.e. Tests 7 to 11 in Appendix 2 of PN 840 (Revised)) to cover not less than two dates during the year. These dates should be random and it is not sufficient to regularly select the month-end.
- scrutinize client ledger accounts to ensure that no accounts had gone into debit and that no incorrect items had been included.
- check bank reconciliations and note subsequent date of clearance of outstanding items, enquiring into reasons for undue delay.
- circularise client ledger accounts on a test basis. If no response is received from the client ledger accounts circularisation, alternative procedures performed should include but not be limited to the examination of subsequent cash receipts and disbursements or a review of documentation and correspondence from clients and third parties.

Practices should ensure that the tests performed cover all branches of the solicitor firm. If there is evidence that the SAR have not been complied with or any matter that appears to affect adversely any client account or any trust money held by the solicitor firm to a material extent, practices shall include details of the contravention or matter in the accountant's report.

2.3) Owners' corporations of buildings ("OC")

Under the Building Management Ordinance ("BMO"), an auditor appointment is made by a resolution passed at a general meeting. The work of the auditor is to conduct the audit in accordance with HKSAs issued by the Institute, including:

- examining, on a test basis, the books and records of the OC;
- assessing significant estimates and judgements made by the management committee ("MC") or the professional property manager in the preparation of the financial statements;
- assessing whether the annual financial statements are free from material misstatements; and
- reporting as to whether the annual financial statements approved by the MC give a true and fair view of the financial statements and financial position of the OC.

Examples of findings

In our inspections, we found instances where practices did not:

- obtain an adequate understanding of the client's operations (e.g. tendering procedures for procurement, funds held for special purposes and nature and operation of each fund) and related key internal controls.
- check minutes of the MC for proper approvals of payments of expenditure, perform a budget to actual expense variance analysis, and obtain an explanation from the MC on any significant variances.
- perform work to test the completeness and accuracy of management fee income, and assess the recoverability of management fee receivables.
- perform work to obtain an understanding of the special purposes of building management and maintenance funds, and to ascertain the appropriateness of the inter fund transfers and the allocation of expenses to each fund.
- consider whether the OC had complied with relevant requirements of the BMO e.g. the requirements to take out insurance for the building against fire and other perils and the code of practice on invitations to order for supplies, goods or services.
- obtain evidence to assess factors which may indicate a potential going concern problem at the OC e.g. correspondence from the Buildings Department in relation to unauthorized or illegal structures which could result in a significant amount of repair liabilities, and evidence of pending litigations.
- perform work to identify related parties of the OC and consider whether the related party transactions (such as consultancy fees) are supported with adequate supporting documents. Related parties may include the developer, the MC, the property manager, and companies controlled by the developer/ the MC/ the property manager.

Practices may refer to the additional practical procedures, extracts of the BMO and example auditor's reports set out in the auditing and assurance circular issued by the Institute: Audit of Financial Statements of Owners' Corporations of Buildings: Audit Issues – Q&As (Revised October 2016) for more information.

3) *Significant accounting and auditing estimates and judgements*

Significant estimates and judgements are subjective by nature, requiring more details to be documented on the audit file to enable another experienced auditor to understand and arrive at the same conclusions.

Examples of findings

Our inspections revealed significant deficiencies in this area. Most findings in this area related to the following:

- failure to adequately challenge management's assumptions in relation to cash flow forecasts for (i) impairment assessment of a cash generating unit or (ii) going concern assessment. Key assumptions included the length of the forecast period, estimated production volume, sales growth rate, selling price, unit cost and operating expenses.
- professional scepticism was not sufficiently applied in assessing the reasonableness of key inputs and assumptions into critical valuation calculations, such as:
  - (1) valuation of an intangible asset (e.g. estimated unit prices and quantities of products sold, discount rate, royalty rate);
  - (2) fair value less cost of disposal and value-in-use of hotel properties (e.g. forecast room and occupancy rates, operating costs, and the discount rate);
  - (3) valuations of unlisted investments; and
  - (4) fair value of the share options granted.
- failure to perform work to determine whether the comparable transactions used by the valuer to determine the asset valuation were reasonable and appropriate.
- failure to identify inconsistencies in respect of the basis of valuation set out in the valuation report (e.g. the market value) and the notes to the financial statements (e.g. the recoverable amount was determined based on value-in-use) and assess the implications for the calculation of the recoverable amount.
- lack of professional scepticism to assess the reasonableness of the inventory provision policy or the appropriateness of the basis of production overheads absorption in work-in-progress and finished goods.
- insufficient challenge of whether product development costs met the criteria for recognition as an intangible asset i.e. identifiability, control (i.e. power to obtain benefits from the asset) and existence of future economic benefits.
- insufficient evidence obtained for recognition of a deferred tax asset. HKAS 12 requires that deferred tax assets should be only recognized to the extent of future taxable profits that these assets can be utilized against.

HKSA 540 (Revised)

Practices should take note of the enhancements in HKSA 540 (Revised) that are effective from the financial year ended 15 December 2019, including:

- an introduction of a separate assessment of inherent risk and control risk for accounting estimates (paragraph 16).
- a requirement to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (paragraph 18).
- a requirement to "stand back" and evaluate the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence (paragraphs 33–35).
- use of stronger language, such as "challenge", "question" and "reconsider", to reinforce the importance of exercising professional scepticism (see, for example, paragraphs A60, A95, and A135).

It is particularly important that the documentation demonstrates how auditors have exercised professional scepticism throughout the audit and specifically includes the following areas required by HKSA 540 (Revised):

- the key elements of the auditor's understanding of the entity and its environment, including internal control relating to accounting estimates;
- the linkage of further audit procedures with the assessed risk of material misstatement at the assertion level;
- the response to situations where management has not taken appropriate steps to understand and address estimation uncertainty;
- indicators of possible management bias, if any, and the auditor's evaluation of the implications for the audit; and
- significant judgments made in the determination of whether the accounting estimates and related disclosures are reasonable, or are misstated, in the context of the applicable financial reporting framework.

4) Application of HKFRSs 9, 15 and 16 and COVID-19 impacts

4.1) HKFRS 9

HKFRS 9 represents a major shift in international accounting practices, adopting a principle-based approach to classification of financial assets and liabilities based on business models and cash flows. The standard also provides for an impairment model to facilitate the recognition of expected credit loss ("ECL"), which aims to better align the accounting treatment with risk management activities.

Examples of findings

In our inspections, we found instances where practices did not:

ECL assessments

- evaluate whether the expected credit loss estimated by the client reflected an unbiased and probability-weighted impairment amount that was determined by evaluating a range of possible outcomes as required by paragraph 5.5.17(a) of HKFRS 9.
- perform work to assess whether the historical default rate was reliable and reasonable. The historical default rate should be determined specific to each group or sub-group of receivables by obtaining observable data from the predetermined period.
- consider relevant forward-looking information in determining the default rates. This could include macroeconomic factors such as interest rates, gross domestic product growth, market sentiment indicators (e.g. purchasing managers' indices) and unemployment rates.
- consider how historical loss rates had been sensitive to changes in macroeconomic factors and determine if there were any observable relationships in cases where the macroeconomic variables were integrated into the ECL estimates. Macroeconomic factors may include those relating to gross domestic product, industrysector growth rates, unemployment (national and regional), inflation, interest rates, property price indexation.
- challenge the client why the general impairment approach was applied to trade receivables that resulted from transactions that were within the scope of HKFRS 15 and did not contain a significant financial component despite there being a material potential impact due to the terms of settlement. For these qualifying assets, HKFRS 9 requires an entity to measure a loss allowance based on lifetime ECLs (i.e. a simplified approach) rather than the three-step process under the general approach. The simplified approach does not apply to intercompany loans.

Accounting for financial instruments

- challenge the appropriateness of classification and measurement of equity investments that were carried at cost less impairment. Under HKFRS 9, an equity investment should be accounted for as financial assets at either (1) fair value through profit or loss ("FVTPL"); or (2) fair value through other comprehensive income ("FVTOCI") (with no recycling to profit or loss).
- assess the appropriateness of classification and measurement of investments in fixed-income securities as financial assets at FVTPL. Under HKFRS 9, investments in equity instruments should be accounted for as financial assets at FVTPL when (1) they are held for trading or to avoid an accounting mismatch and (2) the client does not choose to irrevocably designate the investments at FVTOCI on initial recognition.

- challenge the client's accounting treatment of an investment in a convertible note ("CN") that was stated at cost. The conversion option would cause a CN to fail the solely payments of principal and interest ("SPPI") on the principal contractual cash flow characteristics test. This is because the embedded feature cannot be separated and the contractual terms of the CN as a whole did not give rise solely to payments of principal and interest on the principal amount. The return on the CN is not just consideration for the time value of money and credit risk, but also reflects the value of the issuer's equity. Therefore, a CN in its entirety should be classified as FVTPL under HKFRS 9.

Practices can refer to pronouncements, guides and articles that are relevant to HKFRS 9 in the Institute's website.

4.2) HKFRS 15

According to the core principle of HKFRS 15, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The 5-step approach under HKFRS 15 applies regardless of whether the transaction is a sale of goods or provision of service contract:

Step 1: Identify the contract
Step 2: Identify separate performance obligations
Step 3: Determine transaction price
Step 4: Allocate transaction price to separate performance obligations
Step 5: Determine when to recognize revenue for each performance obligation

Examples of findings

During our inspections, we found instances where practices did not:

- assess whether there were one or more performance obligations based on the contract terms.
- perform work to assess how each type of revenue streams met the criteria for recognition over time set out in HKFRS 15 paragraph 35, e.g. whether customers simultaneously receive and consume the benefits provided from delivery of services as the performance occurs.
- perform a "principal versus agent evaluation" based on indicators under HKFRS 15, i.e. discretion to establish prices for specified goods or services; bearing of inventory and credit risk; primary responsibility to provide specified goods or services, to assess whether the client was a principal or an agent in the sales transaction to support the recognition basis and presentation of revenue.
- identify the type of warranties provided by the client (i.e. assurance-type or service-type) and assess the financial impact. Assurance-type warranties should not be treated as a separate performance obligation under HKFRS 15 and should be accounted for under HKAS 37. Service-type warranties however give rise to a separate performance obligation because additional services are provided to the customer and they should be accounted for under HKFRS 15.

Practices can refer to pronouncements, guides and articles that are relevant to HKFRS 15 in the Institute's website.

4.3) HKFRS 16

HKFRS 16 introduced changes to lessee accounting. Under the previous rules, lessees generally accounted for lease transactions either as off-balance sheet operating leases or as on-balance sheet finance leases. The new standard requires lessees to recognize nearly all leases on the balance sheet which will reflect their right to use an asset for a period of time and the associated liability to pay rentals. The lessor's accounting model largely remains unchanged.

Examples of findings

During our inspections, we found instances where practices did not:

- assess when and the amount at which the modified right-of-use ("ROU") asset and lease liability should be recognized on the extension of a lease. If a lessee enters into a new contract with a lessor (i.e. the original lease agreement remains unchanged) that has the effect of extending the lease term of the existing lease without adding the right to use one of more underlying assets, the new contract should be accounted for as a modification of the existing lease.
- assess the appropriateness of the adjustments to the discount rates used to measure the lease liabilities, such as the length of the lease and the nature and quality of the collateral provided.
- assess the appropriateness of the treatment of the rental concession in determining the ROU assets and lease liabilities. Practices should consider whether a rental concession granted is a lease modification and, if so, remeasure the lease liabilities by discounting the revised lease payments using a revised discount rate at the effective date (i.e. the agreement date).
- challenge the client on the classification of low-value leases e.g. why ROU assets and lease liabilities were not recognised despite the underlying assets were not of low value.

In June 2020, the Institute issued an amendment to HKFRS 16 COVID-19-related Rent Concessions to specify the accounting for changes in lease payments, including rent concessions, as a result of the COVID-19 pandemic. The amendment to HKFRS 16 allows lessees, as a voluntary practical expedient, not to assess whether particular COVID-19-related rent concessions are lease modifications and, instead, account for those rent concessions as if they were not lease modifications. Lessees shall apply the practical expedient consistently to contracts with similar characteristics and in similar circumstances. The practical expedient is not available to lessors.

The amendment is effective for annual reporting periods beginning on or after 1 June 2020, and earlier application is permitted. The educational material published in June 2020 Illustrative examples on COVID-19-related rent concessions provides examples on the application of the optional practical expedient under the Amendment to HKFRS 16 to COVID-19-related rent concessions. Further education material published in January 2020 Illustrative examples on rent concessions provides examples of commonly seen rent concessions in Hong Kong that are not COVID-19-related.

4.4) Impact of COVID-19 on financial reporting and auditing

The global outbreak of COVID-19 has brought unprecedented challenges to practices. With wide-ranging travel restrictions in place for an undetermined period, practices have encountered unanticipated barriers to obtaining evidence (such as audit confirmations) and performing audit procedures, thus requiring practices to modify their audit approaches. Practices also need to perform additional procedures to evaluate the appropriateness of management's assessment of the client entity's ability to continue as a going concern and assess asset impairment resulting from the impact of uncertainty in the business and wider economic environments.

Examples of findings

During our inspections, we found instances where practices did not consider the audit implications arising from the COVID-19 pandemic, including:

- ability of the client entity to continue as a going concern. Consideration should be given to the scenarios and assumptions that client management had used in their going concern assessment and the nature of material uncertainties.
- valuations of non-financial assets, which should require additional levels of judgements and uncertainty because of COVID-19.
- completeness and accuracy of disclosure in the financial statements concerning the possible impact of the pandemic.
- the level of evidence obtained by practices, including third party evidence, which might have been impacted by travel restrictions.

Audit implications due to COVID-19

Practices are advised to:

- proactively discuss with clients to understand whether there is an impact on the client's reporting timetable and the impact on the audit processes;
- reassess whether the audit risks which the initial risk assessment was based may have changed;
- consider performing alternative audit procedures to gather sufficient appropriate audit evidence to support, or modify the audit opinion;
- consider the impact of events after the reporting period on asset valuation or impairment assessment and management's disclosure of relevant risks; and
- consider related financial reporting issues, including:
  - a) the availability of working capital and accuracy of cash flow forecasts, and consequently impact on the appropriateness of the going concern assumption,
  - b) the possibility of impairment of non-financial assets,
  - c) the availability of observable market transactions or information, and consequent difficulties in fair value measurement,
  - d) the possibility of fraudulent sale transactions and impact on the amount and timing of revenue recognition, and
- consider customers' liquidity, and measurement of expected credit loss of trade receivables.

Expectations

We are about to complete the reviews of all active practices. We expect to see improvements in overall audit quality in our next cycle of reviews. We encourage practices to continue to take note of this report's key findings, as well as findings from their internal file reviews, and make appropriate changes to enhance effectiveness of their quality control and audit systems to prevent those deficiencies from occurring in their practice. Practices should also (1) provide **sufficient technical training**, (2) ensure **appropriate supervision and reviews** are carried out on engagements, and (3) emphasize the importance of **applying an appropriate degree of challenge and professional scepticism** in the audit of significant accounting and audit estimates and judgements.

Finally, practices should ensure their engagement partners and other staff are made familiar with the following new and revised auditing standards:

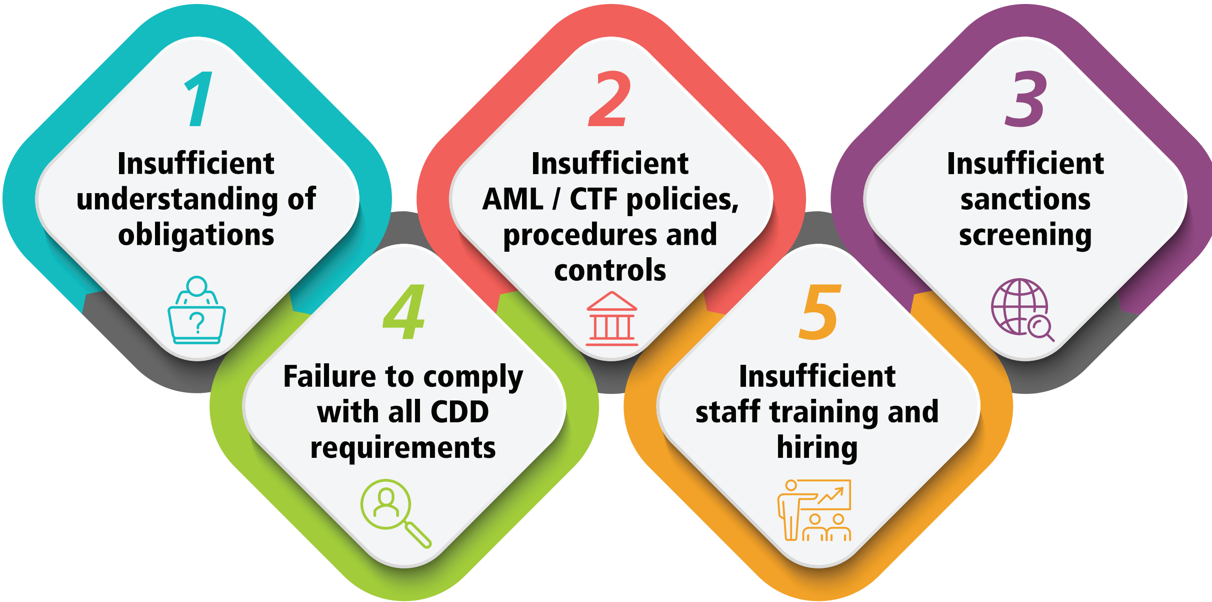
	Professional standards	Effective date
Continuing Professional Development	Statement 1.500 (Revised) *Continuing Professional Development* • Inclusion of the requirements of IES 8 which had been adopted by the Institute since it became effective since July 2016	March 2021
Quality Management	1) ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements or Other Assurance or Related Services Engagements* (previously ISQC 1) 2) ISQM 2 *Engagement Quality Reviews*, and 3) ISA 220 (Revised) *Quality Management for an Audit of Financial Statements* • Final standards published in December 2020 • The new standards introduce a robust, scalable and proactive approach to audit quality management. Given the significance of the changes and the need for practices to adjust how they manage quality, practices would need to set aside resources for implementation and assign responsibility to capable individuals for ensuring compliance with relevant requirements.	15 December, 2022
Audit risk assessment	HKSA 315 (Revised 2019) *Identifying and Assessing the Risks of Material Misstatement*	For 31 December, 2022 audits
Group audit	Proposed ISA 600 (Revised) *Special Considerations – Audits of Group Financial Statements (including the Work of Component Auditors)* • The approval of the final standard is now targeted for December 2021.	December 2023 (expected date)
SME audits	Audits of Less Complex Entities • Targeted date for an exposure draft is June 2021	-
IAASB COVID-19 Response	The IAASB continues to monitor whether further support is needed as the pandemic continues.	-

Our findings

ACMR programme

The Institute's AML Guidelines (Chapter F of the Code of Ethics) were introduced in March 2018. We launched the ACMR programme in October 2018 to assess practices' level of compliance with the AML Guidelines. In an ACMR, we assess the appropriateness of the practice's AML / CTF policies, procedures and controls; review example documents including sanctions screening and CDD, if applicable; and interview the practitioner and staff members of the practice to evaluate their knowledge concerning AML Guidelines compliance. In respect of the issues identified in ACMRs, practices are expected to take actions to address identified gaps or deficiencies in a timely manner. They should monitor the progress made to ensure that remedial actions effectively avoid the recurrence of identified deficiencies.

This section sets out details of the following five weaknesses in practices' AML Guidelines compliance that were more frequently encountered in ACMRs and provides reminders of the relevant guidance to achieve compliance.



1) Insufficient understanding of obligations

Section 600.2 of the AML Guidelines sets out the applicability of the sections:

The AML Guidelines apply to practices as follows:	AML / CTF policies, procedures and controls (Section 610)	CDD, record keeping and ongoing monitoring (Sections 620, 630, 660)	Suspicious transaction reporting and financial sanctions (Sections 640, 650)	Staff hiring and training (Section 670)
When providing **any** service that involved **Specified Transactions**	**Mandatory**	**Mandatory**	**Mandatory**	**Mandatory**
When providing services **other than those** that involved **Specified Transactions**	**Good Practice**	**Good Practice**	**Mandatory**	**Good Practice**

1.1) Determining scope of compliance

The extent to which a practice should comply with the section requirements of the AML Guidelines depends on whether the practice had been or intends to be involved in work to prepare for or carry out Specified Transactions (referred to below as Specified Transaction work) for its clients.

*If **ANY** of the services provided involves **Specified Transactions**:*

✓ ***ALL sections are Mandatory***

Therefore, it is important for a practice to identify whether any of the services that it provides involves Specified Transactions. In our ACMRs, we found that some practices were not aware that their services involved Specified Transactions. Hence, the relevant requirements of the AML Guidelines, including CDD, ongoing monitoring and record keeping, which are mandatory for Specified Transactions, were not complied with. Examples of such engagements include a reporting accountant engagement in respect of a major transaction, very substantial acquisition or disposal transaction relating to buying and selling of business entities or real estate; or an appointment that gives a practice the power to manage a client's bank, saving or securities account.

Practices are reminded that when they consider whether to accept a client engagement, they should obtain sufficient information to enable them to fully understand the nature and purposes of the engagement. If an engagement involves Specified Transaction work, the practice has to comply with all the requirements set out in Sections 610 – 670 of the AML Guidelines.

1.2) Good practices

*If **NONE** of the services provided involves **Specified Transactions**:*

- ✓ ***Sections 640 (Making Suspicious Transaction Reports) and 650 (Financial Sanctions and Terrorist Financing) are Mandatory***
- ✓ ***Other sections can be selected for application as Good Practices***

Unless a practice provides Specified Transaction work, it is not mandatory to comply with sections other than Sections 640 and 650 of the AML Guidelines (e.g. CDD, ongoing monitoring, record keeping, etc.). The practice however may choose to comply with those non-mandatory sections as good practices.

We found that practices which had adopted good practices did not fully comply with all sections of the AML Guidelines (including applying CDD, ongoing monitoring and record keeping measures). If a practice chooses to apply good practices, it should ensure that it has sufficient resources to address all relevant requirements of the AML Guidelines. In an ACMR, review work will be performed to assess how well a practice has applied its AML / CTF policies and procedures, including its application of good practices if the practice has chosen to apply them.

2) Insufficient AML / CTF policies, procedures and controls

Section 610.1 of the AML Guidelines requires practices to put in place internal policies, procedures and controls to address money laundering and terrorist financing (“ML / TF”) concerns and compliance with existing legal requirements on AML / CTF, and communicate these policies and procedures clearly to employees. Practices that do not provide Specified Transaction work should, at minimum, establish policies and procedures to address suspicious transaction reporting and financial sanctions and terrorist financing. Practices should ensure that their AML / CTF policy manuals reflect their circumstances, including whether good practices are to be applied. Common issues identified in practices’ AML / CTF policy manual from our reviews include:

- Having adopted the example policy set out in the AML Procedures Manual for Accountants published by the Institute without appropriate tailoring to suit the circumstances of the practices. This resulted in practices that did not provide Specified Transaction work having adopted all good practice procedures even though they had no intention to apply them as they had no Specified Transaction work. If a practice chooses not to apply good practices, it should not state in its AML / CTF policy manual that CDD and ongoing monitoring procedures are applied to all clients. Instead, its policy manual should state that CDD and ongoing monitoring procedures are applied to only clients, whether new or existing clients, whose engagements involve Specified Transactions.

*Example AML / CTF policy manual for practices which **do not apply good practices** has been uploaded to the Institute's website:*

https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/QA/2019/Example-AML-CTF-policies-and-procedures.pdf

- Insufficient policies and procedures in practices' AML / CTF policy manuals. Examples of contents not covered by practices include:

  Applicable to all practices

  (a) policies and procedures relating to financial sanctions and terrorist financing;

  Applicable to practices providing Specified Transaction work / having adopted good practices

  (b) the frequency of a periodic review of standard and simplified CDD information on their clients as required by paragraph 620.4.2 of the AML Guidelines; and

  (c) a definition of what constitutes an event that triggers a review of CDD information (e.g. material changes in the client's ownership and/ or activities) as required by paragraph 620.10.7 of the AML Guidelines.

We set out below key reminders for practices providing Specified Transaction work or having adopted good practices of the work required to address the following two requirements under the AML Guidelines that have commonly been overlooked when establishing and implementing AML / CTF policies, procedures and controls:

Firm-wide ML / TF risk assessment	Compliance review
• Perform a firm-wide assessment to understand the risks of the practice being used to launder crime proceeds and facilitate terrorist financing • Take into account factors such as types of clients and their geographical locations, services or products offered by the practice, mode of delivery of the services or products, and size of the practice • Based on the assessment results, design appropriate policies, procedures and controls to address the ML / TF concerns	• Perform regular compliance reviews to assess the implementation and effectiveness of the practice's AML / CTF policies, procedures and controls • Frequency and extent of the review should be commensurate with the practice's ML / TF risks and size of its business • Based on the review results, update the practice's policies, procedures and controls

3) Insufficient sanctions screening

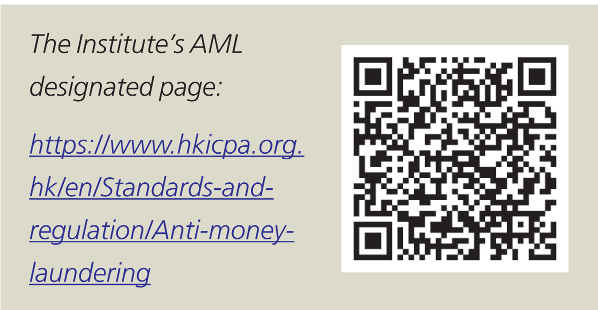
Section 650 of the AML Guidelines (financial sanctions and terrorist financing) is mandatory for all practices regardless of the services provided. There are several pieces of legislation in Hong Kong prohibiting persons from making available financial assets or financial resources to terrorists and individuals and entities sanctioned by the United Nations. The AML Guidelines state that practices must comply with their legal obligations in relation to targeted financial sanctions and the financing of terrorism and proliferation of weapons of mass destruction. Practices must establish financial sanctions and counter-terrorist financing policies and procedures and take measures to ensure compliance with the relevant laws and regulations.

Name screening against sanctions or terrorist lists is an important measure for practices to identify whether their clients are sanctions subjects or terrorists. We found in our reviews that some practices had not implemented sufficient sanctions screening procedures. We set out below key reminders of the work required for sanctions screening:

	Practices that do not use a commercial database	Practices that have subscribed to a commercial database
Initial screening	• Perform before establishment of a client relationship • Check the latest United Nations Security Council consolidated list	• Perform before establishment of a client relationship • Check with the service provider whether the screening facility covers the United Nations sanctions lists before service subscription
Ongoing screening	• Review for updates of sanctions lists monthly if there are no clients with high ML / TF risk, or weekly if there is • Refer to the United Nations Security Council press releases (can be assessed through the Institute's AML designated page) to identify updates of sanctions lists	• Check with the service provider whether the subscription includes ongoing screening and frequency of screening • Analyze alerts of potential hits notified by the service provider
Overall	• Screening should be performed for all clients regardless of the services provided • Keep evidence of screening	

United Nations Security Council Consolidated List:

https://www.un.org/securitycouncil/content/un-sc-consolidated-list


The Institute's AML designated page:

https://www.hkicpa.org.hk/en/Standards-and-regulation/Anti-money-laundering

4) Failure to comply with all CDD requirements

According to paragraph 620.2.1 of the AML Guidelines, CDD information is an important element to determine whether there are grounds for knowledge or suspicion of ML / TF. It is intended to enable practices to form a reasonable belief that they know the true identity of each client and, with an appropriate degree of confidence, know the type of business and transactions that the client is likely to undertake and the source and intended use of funds.

A standard level of CDD measures on a client includes:

- ✓ ***Identification of the client, its beneficial owner(s) ("BO") and the person(s) purporting to act on behalf of the client ("PPTA")***
- ✓ ***Verification of their identities and PPTA's authority to act***
- ✓ ***Obtaining information on the purpose and intended nature of the business relationship***

In ACMRs, we select examples of CDD performed by practices to assess whether they had complied with the relevant requirements. We identified instances where practices failed to comply with all CDD requirements. In the summary below, we set out key reminders on areas where we consider practices should pay attention to when they perform CDD procedures:

Client risk assessment	PPTA
• Assess ML / TF risk of each client • Take into account the client type, geographical location, services offered by the practice, and mode of delivery of the services in the assessment • Draw a conclusion on ML / TF risk so as to determine the extent of CDD (i.e. standard, enhanced or simplified) and frequency of ongoing monitoring	• At minimum, regard the person who is authorized to act on behalf of a client to establish a business relationship with the practice (i.e. the person who has signed or will sign an engagement letter on behalf of the client) as the PPTA • Verify the PPTA's identity, as well as his / her authority to act, in all types of CDD, including simplified CDD

Politically exposed person ("PEP")	Client not physically present for identification purpose

• Perform name checks to identify whether a client and / or its BO(s) are PEP
• Assess ML / TF risk of domestic PEP
• For foreign PEP and high risk domestic PEP, perform enhanced CDD procedures which should include:
  ◦ Obtaining senior management approval before commencing or continuing the client relationship;
  ◦ Taking reasonable measures to establish the sources of wealth and funds of the PEP;
  ◦ Assessing specific risk factors in paragraph 620.12.13; and
  ◦ Reviewing CDD information at least annually
	• Apply equally effective client identification procedures and ongoing monitoring standards for a client not physically present for identification purposes as for those where the client is available for interview
	• Perform at least one of the following measures:
	  ◦ Further verify the client's identity by obtaining additional documents, data or information from a reliable and independent source, that are not previously used to verify the client's identity;
	  ◦ Take supplementary measures to verify the information relating to the client that has been obtained by the practice (e.g. use of a suitable certifier)

5) Insufficient staff training and hiring

Effective staff training and hiring procedures can facilitate practices to prevent and detect ML / TF activities. The AML Guidelines require practices to provide appropriate and adequate AML / CTF training to staff members and to establish policies and procedures to ensure integrity of new employees. In ACMRs, we found that some practices had not implemented sufficient procedures to achieve compliance with staff training and hiring requirements. The table below shows some key reminders for practices to enhance compliance in those respects:

Staff training	Staff hiring
• Provide regular AML / CTF training to all relevant staff members • Training materials should cover all essential topics (e.g. suspicious transaction reporting, restrictions relating to tipping off and CDD procedures) • Implement measures to monitor training effectiveness (e.g. arranging a quiz)	• Implement procedures (e.g. name screening) to ensure integrity of new employees • Equip new employees with AML / CTF knowledge before they commence work (e.g. conducting new joiner AML / CTF training)

Although Section 670 (staff training and hiring) is mandatory for practices providing Specified Transaction work or having adopted good practices, we recommend other practices to provide relevant AML / CTF training to employees to ensure they at least understand:

- ✓ ***What is ML / TF***
- ✓ ***The need and how to identify and report suspicious transactions to the money laundering reporting officer; and the offence of tipping off***
- ✓ ***Policies and procedures concerning financial sanctions and terrorist financing***

The Institute has developed and will continue to develop answers to FAQs regarding AML / CTF compliance which are posted on the Institute's website. The FAQs provide practical resources that assist practices in complying with the requirements of the AML Guidelines, including an example policy for practices that do not adopt good practices and links to online resources for sanctions checks. The FAQs can be found at: https://www.hkicpa.org.hk/en/Tools/FAQ/Quality-assurance/Practice-review---AML-Monitoring.

FAQs on AML monitoring

Our findings

Professional standards monitoring programme

The objective of the professional standards monitoring programme is ultimately to enhance the quality of financial reporting and the application of professional standards in Hong Kong. We carry out regular reviews of the financial statements of Hong Kong listed companies to assess their compliance with professional standards. This report summarizes the key observations from our reviews in 2020. We hope that members would find information and discussions in this report useful and inspiring.

The programme is a financial statements review programme. While our scope of review covers the application of all HKFRSs and other professional standards, we place more focus on reviews of the application of new and revised financial reporting standards. In our 2020 reviews, we gave priority to review the initial application of HKFRS 16 *Leases* that became effective in 2019. The relevant key observations from our review of its initial application are discussed in Section I.

The other two major new financial reporting standards, HKFRS 9 (2014) *Financial Instruments* and HKFRS 15 *Revenue from Contracts with Customers*, have been effective for three years since 2018. Given their complex requirements and wide-range impact on financial statements of many entities, the application of these two HKFRSs continued to be our review focus in 2020. We share observations from our reviews of their application in Section II. This year, we have also chosen to share with members a new issue in respect of application of HKFRS 10 *Consolidated Financial Statements* identified from our reviews. Finally, Section III provides a summary of common disclosure deficiencies identified from our reviews.

The pandemic COVID-19 outbreak had brought a lot of challenges to many entities, including preparers and auditors of financial statements. Some relevant financial reporting issues were discussed in the relevant parts of this report as appropriate.

Section I – Initial application of HKFRS 16

HKFRS 16 has an impact on all entities that have lease contracts falling within HKFRS 16 scope. However, there are certain industry sectors which might be more impacted by HKFRS 16 due to their business being largely associated with leasing activities, e.g. entities engaged in retailing, shipping and aviation businesses. Therefore, our 2020 reviews have covered a sample of financial statements of companies of those industries.

HKFRS 16 is considered to be a far reaching standard, particularly on the lease accounting by lessees. It applies a single lease accounting model, which is called a "right-of-use model" under which the distinction between a finance lease and an operating lease from the perspective of a lessee is eliminated. Accordingly, the major effect is the recognition of right-of-use ("ROU") assets and lease liabilities in the lessee's statement of financial position (i.e. "On balance sheet") as contrasted to the previous treatment under HKAS 17 *Leases* where operating expenses were recognized in the income statement (i.e. "Off balance sheet"). The recognition and measurement requirements of the ROU assets and lease liabilities and the related issues identified are further discussed later in this Section.

HKFRS 16 also requires enhanced disclosures by both lessees and lessors. The end of this Section covers common disclosure deficiencies identified from our reviews particularly on HKFRS 16.

1. On transition – the first time adoption

Unless HKFRS 16[1] is early applied, an entity shall apply HKFRS 16 for annual periods beginning on or after 1 January 2019.

HKFRS 16 provides some reliefs on transition. As a practical expedient, an entity is <u>not required</u> to reassess its existing contracts to determine whether they contain a lease at the date of initial application. Instead, an entity is permitted (1) to apply HKFRS 16 to contracts that were previously identified as leases applying HKAS 17 and HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*; and (2) not to apply HKFRS 16 to contracts that were not previously identified as containing a lease applying HKAS 17 and HK(IFRIC)-Int 4. If an entity chooses this expedient it shall disclose that fact and apply it to <u>all of its contracts</u>, regardless of whether the entity is a lessee or lessor. This would mean that the entity shall apply the HKFRS 16 definition of a lease to assess whether contracts entered into (or changed) on or after the date of initial application meet the definition of a lease (HKFRS 16 paragraphs C3 and C4).

[1] Earlier application of HKFRS 16 is permitted for entities that apply HKFRS 15 *Revenue from Contracts with Customers* at or before the date of initial application of HKFRS 16. If an entity chooses to apply HKFRS 16 earlier, it must disclose that fact (HKFRS 16 paragraph C1).

The main impact of HKFRS 16 is on the accounting for leases by lessees. A lessee applies HKFRS 16 to its leases either:

(a) Retrospectively to each prior reporting period presented applying HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* ("full retrospective approach"); or

(b) Retrospectively with the cumulative effect of initially applying HKFRS 16 recognized at the date of initial application in accordance with HKFRS 16 paragraphs C7 to C13 ("modified retrospective approach").

If the modified retrospective approach is elected, the lessee is not required to restate comparative information and the cumulative effect of initially applying HKFRS 16 shall be presented as an adjustment to the opening balance of retained earnings (or other equity component of equity, as appropriate) at the date of initial application (HKFRS 16 paragraph C7). Such election is required to be applied consistently to all of an entity's leases in which it is a lessee (HKFRS 16 paragraph C6).

All the financial statements reviewed showed that the modified retrospective approach was used upon initial application of HKFRS 16. We identified issues in the application of detailed requirements set out in the transition provisions.

Leases previously classified as operating leases

Under HKFRS 16 paragraph C8(b), if a lessee elects to adopt the modified retrospective approach, the lessee shall *"recognise a right-of-use asset at the date of initial application for leases previously classified as an operating lease applying HKAS 17. The lessee shall choose, on a lease-by-lease basis, to measure that right-of-use asset at either*:

(i) its carrying amount as if the Standard had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; **[Method 1]** *or*

(ii) an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application" **[Method 2]**. (underline added)

A set of financial statements reviewed disclosed that the group's ROU assets at 1 January 2019 were measured based on the carrying amounts as if HKFRS 16 had always been applied since the commencement date, except for the incremental borrowing rate where the group applied the incremental borrowing rate at 1 January 2019. Such disclosure indicated that "Method 1" as referred to above was applied. The reporting entity, however, provided a table showing that the total amount of ROU assets recognized in its consolidated statement of financial position exactly equaled to the lease liabilities on initial application of HKFRS 16, which indicated that "Method 2" was actually applied. Without further explanation in the financial statements, the inconsistent information disclosed created confusion as to whether Method 1 or Method 2 was applied by the reporting entity.

In another example reviewed, the disclosures stated that the reporting entity recognized additional lease liabilities and ROU assets at the amounts equaled the related lease liabilities applying HKFRS 16 paragraph C8(b)(ii) (i.e. "Method 2" as referred to in the above). The disclosures further explained that, when applying the modified retrospective approach at transition, the reporting entity applied certain practical expedients to leases previously classified as operating leases under HKAS 17, on a lease-by-lease basis, including the practical expedient to rely on the assessment of whether leases were onerous applying HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as an alternative to impairment review.

HKFRS 16 paragraph C8(c) requires that, if a lessee elects to apply the modified retrospective approach, the lessee shall apply HKAS 36 *Impairment of Assets* to ROU assets at the date of initial application, unless the practical expedient in HKFRS 16 paragraph C10(b) is applied. The practical expedient under HKFRS 16 paragraph C10(b) allows a lessee to rely on its assessment of whether leases are onerous applying HKAS 37 immediately before the date of initial application as an alternative to performing an impairment review. The lessee that applies this practical expedient shall adjust the ROU asset at the date of initial application by the amount of any provision for onerous leases recognized in its statement of financial position[2].

The disclosed financial information of the above reporting entity showed that a segment of the reporting entity had had poor financial performance for years (e.g. consecutive segment losses for years and impairment losses having been recognized on some major assets of that particular segment including goodwill and intangible assets). Without further information, it was unclear whether the leases entered into under that segment business, had become onerous applying HKAS 37 immediately before the date of initial application of HKFRS 16. However, no relevant provision for onerous lease contracts had been made and hence the ROU assets had not been adjusted at the initial application of HKFRS 16 despite having disclosed that the practical expedient under HKFRS 16 paragraph C10(b) was applied. We noted that the reporting entity recognized an impairment loss on the ROU assets during the year and the net carrying amount of the ROU assets became no longer material to the group financial statements. However, in this example, it was questionable whether the reporting entity had applied HKAS 37 appropriately prior to the initial application of HKFRS 16. If not, it would not have been appropriate for the entity to apply the practical expedient under HKFRS 16 paragraph C10(b) in order not to perform an impairment review of the ROU assets at initial application of HKFRS 16.

[2] The International Accounting Standards Board ("IASB") noted that it could be costly for a lessee to perform an impairment review of each of its ROU assets on transition to IFRS 16. In addition, any onerous operating lease liability identified applying IAS 37 is likely to reflect impairment of the ROU asset. Accordingly, the IASB concluded that this practical expedient will provide a cost saving to lessees on initial application of IFRS 16 without any significant effect on reported information (HKFRS 16 BC 287).

2. Overview of HKFRS 16 and related application issues identified

The following table gives an overview of the major impact on the financial statements presentation as a result of adoption of HKFRS 16:

Diagram 1 Lessee accounting – comparison between HKFRS 16 and HKAS 17 on financial statements presentation

	HKFRS 16	HKAS 17
Statement of financial position	✓ Right-of-use assets **(Note a)** ✓ Lease liabilities **(Note a)** [HKFRS 16 paragraphs 47 and 48]	✓ Not recognized except for rental deposits paid
Statement of profit or loss and other comprehensive income	✓ Interest expenses recognized on the lease liabilities under the effective interest method **(Note b)** ✓ Depreciation charge for the right-of-use assets **(Note b)** [HKFRS 16 paragraph 49]	✓ Operating lease expenses
Statement of cash flows	✓ Cash payments for the principal portion of the lease liability within **financing** activities ✓ Cash payments for the interest portion of the lease liability presented consistently with other interest payments applying the requirements in HKAS 7 *Statement of Cash Flows* ✓ Short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within **operating** activities [HKFRS 16 paragraph 50]	✓ Lease payments under cash flows within **operating** activities

Note:

a. The presentation of ROU assets and lease liabilities shall be distinguished from other assets and liabilities either by separate presentation in the statement of financial position or disclosure in the notes (HKFRS 16 paragraph 47(a) and (b)). The requirement in HKFRS 16 paragraph 47(a) does not apply to ROU assets that meet the definition of investment property, which shall be presented in the statement of financial position as investment property (HKFRS 16 paragraph 48).

b. Interest expense on the lease liability shall be presented separately from the depreciation charge for the ROU asset. Interest expense on the lease liability is a component of finance costs which shall be presented separately in the statement of profit or loss and other comprehensive income under HKAS 1 (Revised) *Presentation of Financial Statements* paragraph 82(b) (HKFRS 16 paragraph 49).

The discussions below focus on some key requirements and related observations identified in regard to lessee accounting:

(i) <u>Identifying a lease and separating lease and non-lease components of a contract</u>

In order to determine whether HKFRS 16 should be applied, an entity shall first assess whether the contract or the arrangement is or contains a lease; and if it is a lease, whether it is within the scope of HKFRS 16. HKFRS 16 applies to all lease contracts, including leases of ROU assets in a sublease, except for the following lease contracts specifically covered by other HKFRSs:

- Leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- Service concession arrangements within the scope of HK(IFRIC) - Int 12 *Service Concession Arrangements*;
- For lessees, leases of biological assets within the scope of HKAS 41 *Agriculture* and rights held under licensing agreements within the scope of HKAS 38 *Intangible Assets* for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and
- For lessors, licences of intellectual property within the scope of HKFRS 15.

(HKFRS 16 paragraph 3)

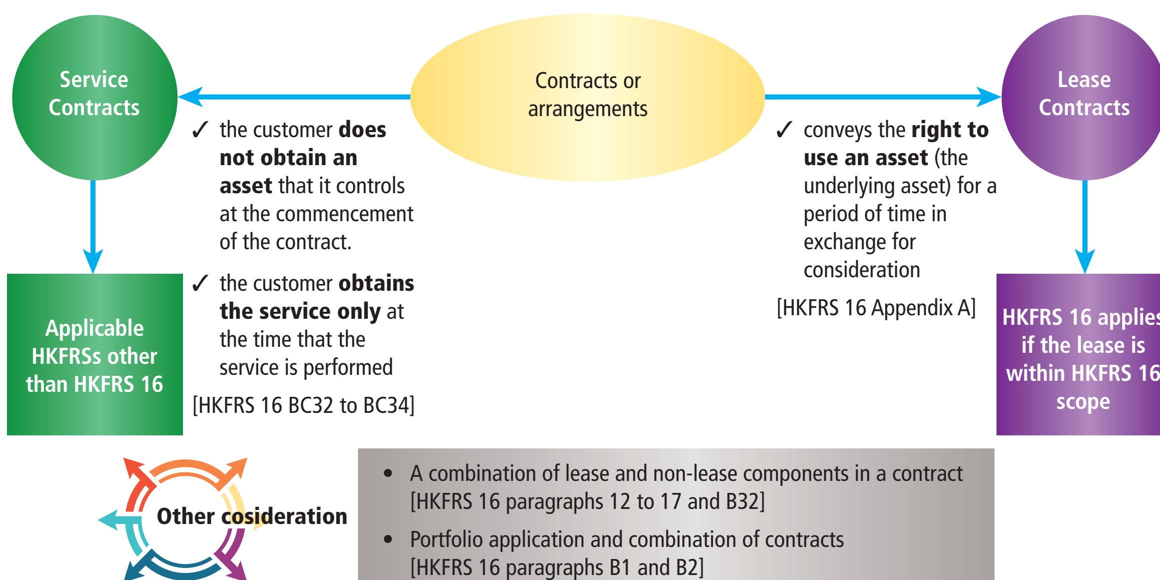
A lessee is permitted, but not required, to apply HKFRS 16 to leases of intangible assets other than those as described in the third bullet above (HKFRS 16 paragraph 4).

Lease accounting in HKFRS 16 considers the rights and obligations created by a lease from <u>the perspective of the lessee</u> (HKFRS 16 BC19).

A lease or a service contract?

In practice, it may sometimes be challenging to distinguish between a lease contract and a service contract. The determination could result in significant differences in the accounting treatment.

Diagram 2 Distinguishment between lease contracts and service contracts (Note a)



Note:

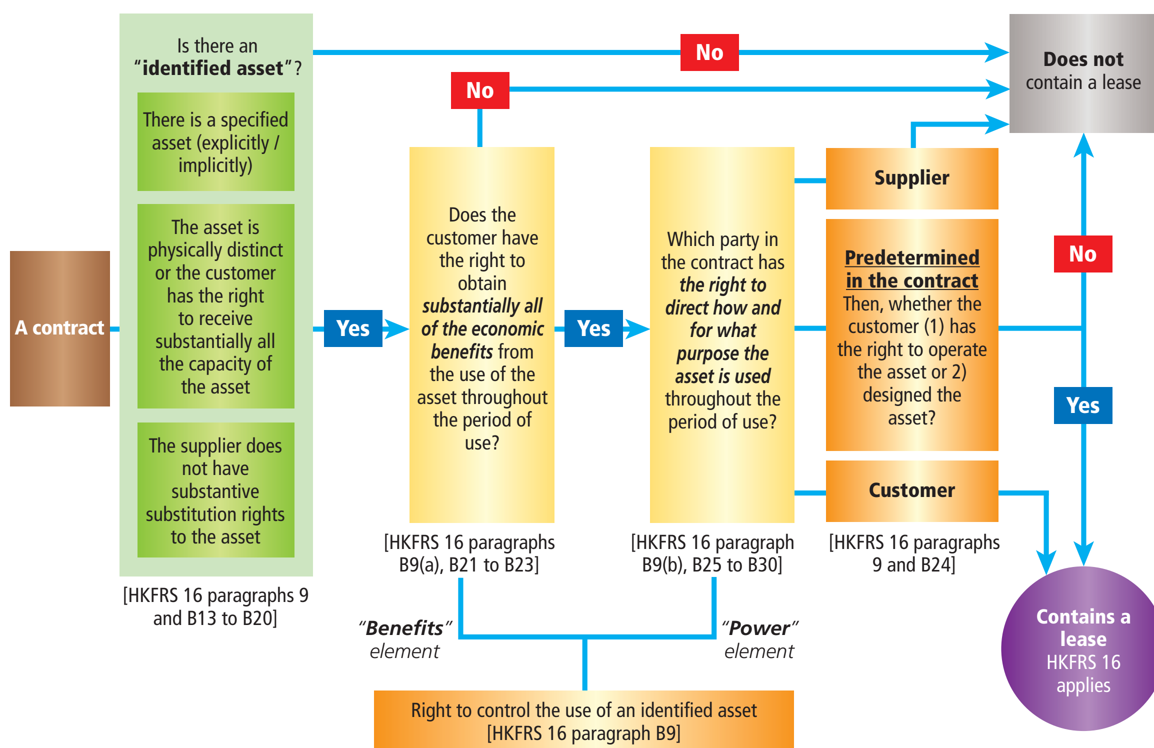
a. The purpose of this diagram is to highlight the key differences between a lease contract and a service contract. There may be situations where there are leases of intangible assets. In those situations, entities should pay attention to the requirements of HKFRS 16 paragraphs 3 and 4 to determine whether they should be accounted for applying HKFRS 16 or other applicable HKFRSs (e.g. HKAS 38 *Intangible Assets*).

HKFRS 16 defines a lease as *"A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration"* (HKFRS 16 Appendix A). The determination of whether a contract is, or contains, a lease should be performed at the inception of the contract (HKFRS 16 paragraph 9).

All contracts create rights and obligations for the parties to the contract (HKFRS 16 BC 19). To distinguish between a lease and other contracts, e.g. a service contract, the IASB concluded that a lease creates rights and obligations that are different from those that arise from a service contract. The lessee obtains the right to control the use of an identified asset (i.e. obtains a ROU asset) at the time that the underlying asset is made available for use by the lessee. However, in a typical service contract, the customer does not obtain an asset that it controls at the commencement of the contract. Instead, the customer obtains the service only at the time that the service is performed. The supplier retains the control of the asset (HKFRS 16 BC32 to BC34).

The following diagram sets out the decision making process for the determination of whether a contract or an arrangement is, or contains, a lease. Judgement may be required in the practical application.

Diagram 3 Lessee accounting – determination of whether there is a lease (at contract inception)



The above diagram shows that, an entity has the right to control the use of an identified asset only if it has the right to obtain substantially all of the economic benefits from the use of the asset ("benefit element") and also has the ability to direct the use of the asset, i.e. to decide how and for what purpose the asset is used ("power element"). This control model, which contains both the "benefit element" and "power element", is consistent with those applied in HKFRS 10 and HKFRS 15.

Identifying and separating lease and non-lease components of a contract

HKFRS 16 paragraph 12 states that an entity shall identify and account for each lease component within a contract as a lease separately from non-lease components of the contract, unless the entity (lessee only) applies the practical expedient in HKFRS 16 paragraph 15. The right to use an underlying asset is a separate lease component if both two criteria are met:

> Criterion 1: The lessee can benefit from the use of the underlying asset either on its own or together with other resources readily available to the lessee; and
>
> Criterion 2: The underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.
>
> [HKFRS 16 paragraph B32]

The right to use multiple assets is considered as a single lease component if one or both of the above criteria are not met. For example, in a lease contract which involves a lease of multiple assets and the lessee would not be able to benefit from the use of one underlying asset without also using the other underlying assets, then the lease contract should be considered to have contained one lease component from the perspective of the lessee as Criterion 1 under HKFRS 16 paragraph B32 is not satisfied. Members may refer to HKFRS 16 IE4 (Example 12) which illustrates how to apply HKFRS 16 paragraph B32 to identify lease components in a lease contract.

For a contract that contains a lease component and one or more additional lease and non-lease components, unless the practical expedient is applied (see below), the lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components. Members may refer to HKFRS 16 paragraphs 13 to 16 for further guidance. An example is also provided in HKFRS 16 IE4 (Example 12) to illustrate how the requirements should be applied.

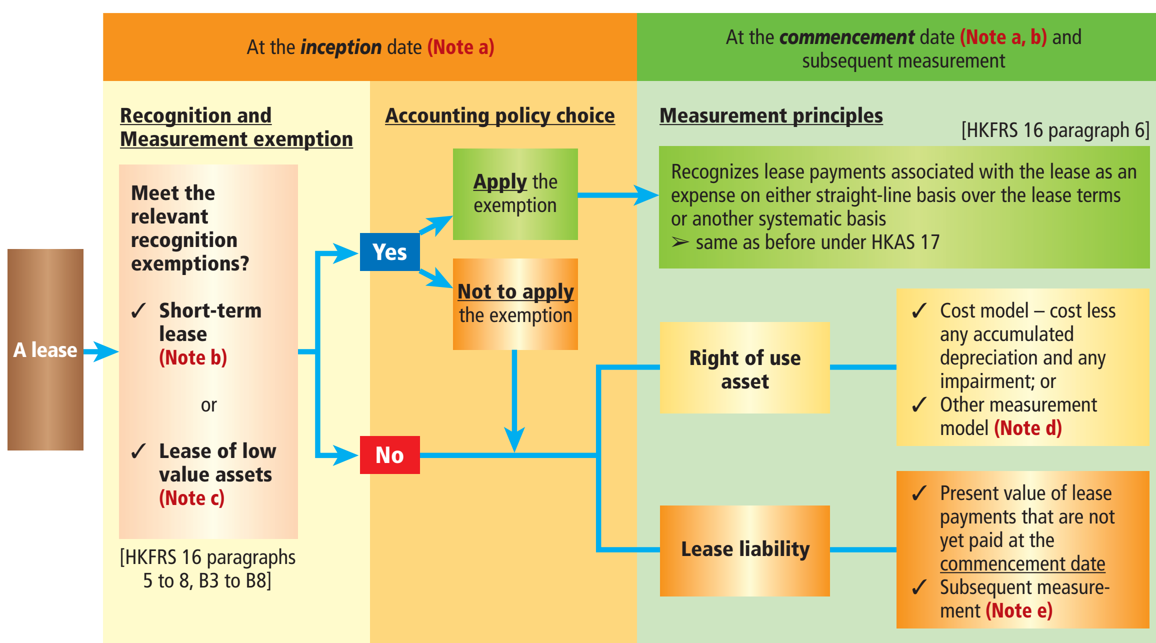
As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead accounts for each lease component and any associated non-lease components as a single lease component (HKFRS 16 paragraph 15). It is worth noting that the practical expedient does not allow lessees to account for multiple lease components of a contract as a single lease component.

Based on our 2020 reviews, so far we have identified some issues concerning the recognition and measurement of lease liabilities and consequently ROU assets that should be recognized at the lessee's statement of the financial position, which are further discussed below.

(ii) Recognition and measurement of a lease (from lessee's perspective)

After determining that the contract or the arrangement is, or contains, a lease, the next step is to account for the lease by recognizing a ROU asset and a lease liability on the lessee's statement of financial position based on the HKFRS 16 requirements. The following two diagrams summarize the major requirements for accounting for a lease by a lessee:

Diagram 4 Lease accounting "after" determining that there is a lease



Note:

a. There are differences between "inception date" and "commencement date" under HKFRS 16. By definition, "inception date" of a lease is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms of a lease; whereas "commencement date" refers to a date on which a lessor makes an underlying asset available for use by a lessee (HKFRS 16 Appendix A)

b. A lease that, at the commencement date, has a lease term of 12 months or less. A lease that contains a purchase option is not a short-term lease (HKFRS 16 Appendix A). The exemption for a short-term lease shall be applied consistently by class of underlying assets. Therefore, once a lessee has developed an accounting policy for a class of underlying assets, all future short-term leases for that class are required to be treated consistently under the policy.

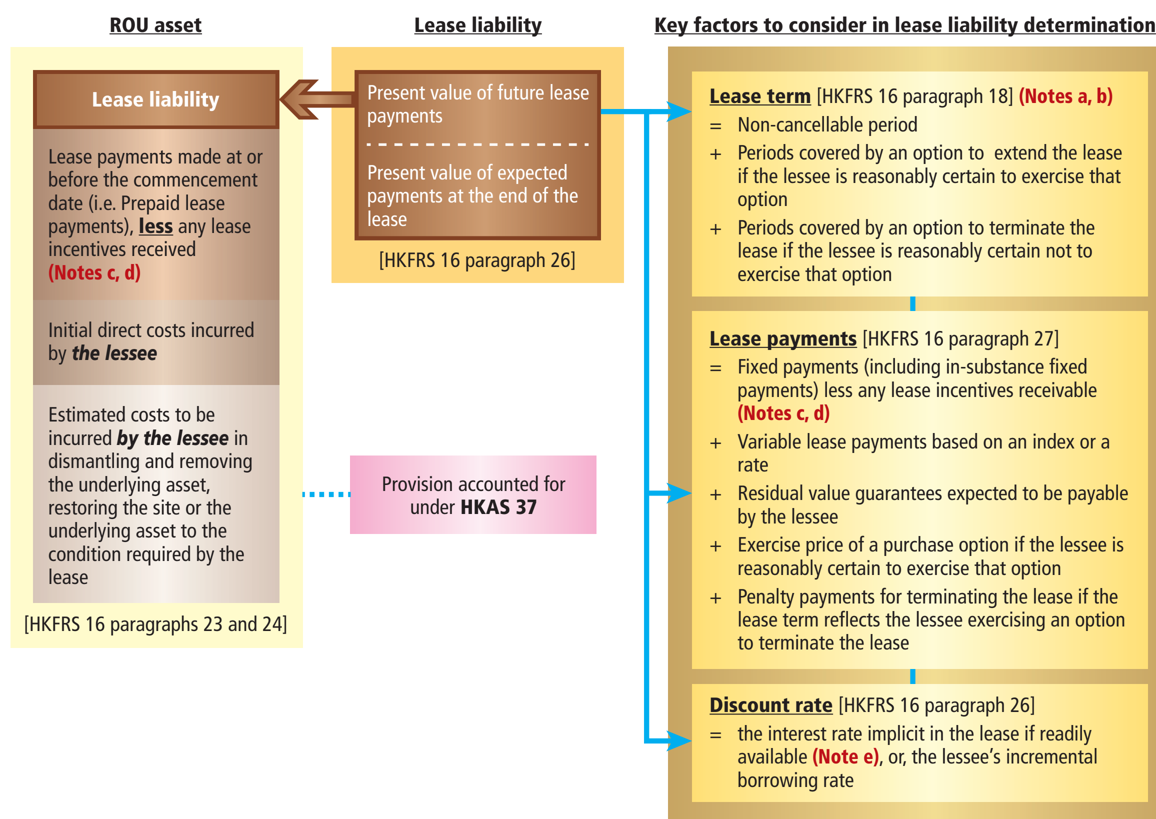
c. The exemption for lease of low value asset can be applied on a lease-by-lease basis. The assessment does not take into account whether low-value assets in aggregate are material. Therefore, the exemption still applies even if the aggregated low-valued assets are material.

d. If a lessee applies the fair value model in HKAS 40 *Investment Property* to its investment property, the lessee shall also apply the fair value model to ROU asset that meets the definition of investment property under HKAS 40 (HKFRS 16 paragraph 34). If ROU assets relate to a class of property, plant and equipment ("PPE") to which the lessee applies the revaluation model in HKAS 16 *Property, Plant and Equipment*, a lessee may elect to apply that revaluation model to all of the ROU assets to that class of PPE (HKFRS 16 paragraph 35).

e. HKFRS 16 paragraph 36 requires that, after the commencement date, a lessee shall measure the lease liability by: (1) increasing the carrying amount to reflect interest on the lease liability; (2) reducing the carrying amount to reflect the lease payments made; and (3) remeasuring the carrying amount to reflect any reassessment or lease modifications specified in HKFRS 16 paragraphs 39 to 46, or to reflect the revised in-substance fixed lease payments (see HKFRS 16 paragraph B42).

The following diagram shows the components that make up a ROU asset and a lease liability under HKFRS 16.

Diagram 5 Components of ROU asset and lease lability



Note:

a. The lease term begins on the commencement date (i.e. the date on which the underlying asset is available for use) and therefore includes any rent-free periods provided to the lessee by the lessor (HKFRS 16 paragraph B36).

b. The assessment of whether the lessee is reasonably certain to exercise an option to extend or to purchase the underlying asset, or not to exercise an option to terminate the lease is performed at the commencement date of a lease (HKFRS 16 paragraphs 19 and B37).

c. "Lease incentives" are defined as "payments made by a lessor associated with a lease, or the reimbursement or assumption by a lessor of costs of a lessee" (HKFRS 16 Appendix A).

d. For lessees, lease incentives that are received by the lessee at or before the commencement date of a lease reduce the initial measurement of a lessee's ROU asset (HKFRS 16 paragraph 24(b)). Lease incentives that are receivable by the lessee at the commencement date of a lease reduce a lessee's lease liability and therefore also reduce the ROU asset (HKFRS 16 paragraph 27(a)).

e. "Interest rate implicit in the lease" is defined as "the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor (HKFRS 16 Appendix A).

Under HKFRS 16, the total lease expense[3] would be more front-loaded in the earlier life of a lease; and accordingly, the carrying amount of ROU asset generally would be less than the carrying amount of lease liability recorded in the lessee's statement of financial position in subsequent periods.

(a) Recognition exemption of "low-value assets"

As shown in *Diagram 4*, a decision point is to choose whether or not to apply the recognition exemption for short-term leases and leases of low-value assets; and if so, a simplified method of accounting for those leases would be applied, i.e. recognizing lease payments in profit or loss instead of recognizing a lease liability and a ROU asset on the statement of financial position.

The determination of whether an asset qualifies as low value requires judgement and such result of assessment might sometimes change over time. For example, due to technology evolution, a technology equipment not considered to be low-value today might become a low-value item someday in future and therefore the lessee might then be able to apply the low-value asset exemption for those leases entered into at that time. The election for leases of low-value assets can be made on a lease-by-lease basis and therefore two assets leased by an entity can be accounted for differently.

A lease of an underlying asset does not qualify as a lease of low-value asset if the nature of the asset is such that, **when new**, the assets is typically not of low value. Such assessment is not affected by the size, nature or circumstances of the lessee and accordingly, different lessees are expected to reach the same conclusion about whether a particular underlying asset is of low value (HKFRS 16 paragraph B4).

We encountered a reporting entity which disclosed that it had applied the recognition exemption for leases of low value items which included motor vehicles. However, HKFRS 16 paragraph B6 states that leases of cars would not qualify as leases of low-value assets because a new car would typically not be of low value. At the time of reaching decisions about the exemption, the IASB also had in mind leases of underlying assets with a value, when new, of US$5,000 or less (HKFRS 16 BC100). Therefore, in this example, applying the recognition exemption for motor vehicles (of which their value, when new, are typically not low) was not appropriate, although the related financial impact was not expected to be material based on our further assessment of information available.

(b) In-substance fixed payments – impact on determination of lease payments

As shown in *Diagram 5*, "fixed lease payments" is one of the lease payment components relating to the use of underlying asset in the initial measurement of lease liability. As stated in HKFRS 16 paragraph 27(a), the fixed lease payments include "in-substance fixed payments" which are payments, that may, in form, contain variability but that, in substance, are unavoidable. Examples of "In-substance fixed payments" are provided in HKFRS 16 paragraph B42.

[3] The total lease expense recognized in profit or loss consists of (1) interest expense on lease liability under the effective interest method; (2) depreciation expense of the ROU asset and (3) variable lease payments not included in the lease liability.

A reporting entity engaged in food retailing disclosed in its financial statements that the group leased a number of retails stores and units that contained variable payment terms and some leases included "minimum or cap clauses". There was no further information provided in the financial statements regarding the "minimum or cap clauses". Given the disclosures indicated that a substantial amount of the group's variable lease payments were not included in the measurement of lease liabilities for the year, we were concerned whether any "minimum clauses" were "in-substance fixed payments" as envisaged under HKFRS 16 paragraph 27(a) but inappropriately excluded from the initial measurement of the lease liabilities at the commencement date. An enquiry was therefore raised with the auditor to ask them to provide information about those clauses and how management considered them in the accounting for the relevant leases.

In response to our enquiry, the auditor advised that the minimum lease payments specified in the lease contracts under the "minimum or cap clauses" had already been considered by management in the determination of the total lease payments used to calculate the lease liabilities at the commencement date. The response also advised the audit procedures performed to ensure that the clauses set out in the leases were adequately and appropriately considered in the initial measurement of lease liabilities at the commencement date. Having considered the auditor's explanation collectively with information of other note disclosures, we found that the substantial variable lease payments that were not included in the measurement of lease liabilities were those variable lease payments that depended on turnover of the lessees' retail stores (i.e. did not depend on an index or rate) and hence it was appropriate for them to be recognized as an expense in the period incurred under the reporting entity's accounting policy.

We recommend preparers of financial statements provide some descriptions of key clauses (such as in this example, some description about the "minimum or cap clauses"); and where relevant and appropriate, also disclose the accounting policy for determining "in-substance fixed payments" and management's judgement exercised in the application of the accounting policy such that users of financial statements can better understand reporting entities' leasing activities and their application of HKFRS 16.

(c) Extension and termination options – impact on lease term determination

Diagram 5 shows that the lease term is the non-cancellable period of the lease, together with both (1) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise the option; and (2) periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option (HKFRS 16 paragraph 18).

A reporting entity's financial statements stated that the group had lease contracts which included extension and termination options and further discussions of those options would be provided in the financial statements. However, when we looked further into the financial statements, there was in fact no further information about those extension and termination options disclosed. In order to assess whether the reporting entity had appropriately applied HKFRS 16 to determine the lease terms in view of the extension and termination options, an enquiry was raised to ask the auditor to explain the

conditions for exercising the extension and termination options included in the group's lease contracts and management's judgement applied in assessing the impact of the extension and termination options in the accounting for the leases.

The auditor clarified in its response that there was in fact no termination option included in any of the lease contracts entered into by the reporting entity. In regard to the extension options, the response explained that there was a renewal term in certain lease contracts of the group and management considered that such renewal term in substance provided the group (lessee) with the right to extend the relevant leases. The response also provided the factors considered by management when assessing whether to exercise the extension options (e.g. expected market rental fluctuations, cost of relocation and the remaining economic life of the non-removable leasehold improvements). After consideration of those factors, the lease term of the contracts was determined taking into account both the non-cancellable period and period covered by the extension options (for those leases that management was reasonably certain to exercise the extension options).

As required by HKFRS 16, at the commencement date, an entity assesses whether the lessee is reasonably certain to exercise an option to extend the lease or to purchase the underlying asset, or not to exercise an option to terminate the lease (HKFRS 16 paragraphs 19 and B37). If a lessee is reasonably certain to extend the lease, all of the payments that the lessee would be contractually obliged to make over that longer period will be part of the initial lease liability. Similarly, the lessee is reasonably certain to terminate the lease at an earlier date, any termination payment will be part of the lease liability.

It is foreseeable that the longer the period between the commencement date and the exercise date of the option, more uncertainty would be involved in assessing whether the lessee would exercise the option[4]. Consideration of all facts and circumstances by the lessee that create an economic incentive for the lessee to exercise, or not to exercise the option, including any expected changes in facts and circumstances from the commencement date until the exercise date of the options, is therefore particularly essential. Such assessment should be based on the facts and circumstances at the commencement date of the lease. The diagram below lists out examples of factors for consideration by a lessee.

[4] Some entities may enter into a series of short-term leases, with a renewal option, in order to apply the short-term lease recognition exemption provided under HKFRS 16 paragraph 6. However, HKFRS 16 paragraph B39 states that the shorter non-cancellable period of a lease, the more likely a lessee is to exercise an option to extend the lease or not to exercise an option to terminate the lease. This is because the costs associated with obtaining a replacement asset are likely to be proportionally higher the shorter the non-cancellable period.

Diagram 6 Examples of factors to consider whether a lessee is reasonably certain to exercise an extension or termination option (not exhaustive)

Note:

a. Costs relating to the termination of the lease e.g. negotiation costs, relocation costs, costs of identifying alternative underlying assets that suit for the lessee's needs [HKFRS 16 paragraph B37(c)]

b. Importance of the underlying asset to the lessee's operation, e.g. whether it is a specialized asset, the location of the underlying asset and the availability of suitable alternatives [HKFRS 16 paragraph B37(d)]

c. A lessee's past practice regarding the period over which it has typically used particular types of assets and its economic reasons for doing so. [HKFRS 16 paragraph B40]

[HKFRS 16 paragraphs B37 - B40]

The auditor's explanation in the example discussed above showed that management had considered relevant factors concerning the extension options in determining the lease terms.

HKFRS 16 does not provide guidance on how to weigh the individual factors and circumstances of a lessee when determining whether the lessee is reasonably certain to exercise an option included in a lease. Therefore, significant judgement might be needed to make this assessment and information about the judgement exercised should be disclosed in the financial statements as required by HKAS 1 (Revised) paragraph 122.

Members should also note the detailed requirements set out in HKFRS 16 paragraphs 20 and 21 concerning (1) when a lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option; and (2) when a lessee shall revise the lease term, respectively. Under HKFRS 16, "lease reassessment" is different from "lease modification". A key difference is that a reassessment should be performed[5] if the change in cash flows is based on contractual clauses that have been part of the original lease contract. Changes resulting from renegotiations of lease terms (not part of the original lease terms) are regarded as "lease modification" which are further discussed in (d) below.

(d) Lease modification – subsequent measurement

A table set out in a reporting entity's financial statements showed that there was a decrease in the carrying amount of the ROU assets of the group's motor vehicles during the year due to "Termination". No further relevant information of this "Termination" was found in the financial statements. In particular, the financial

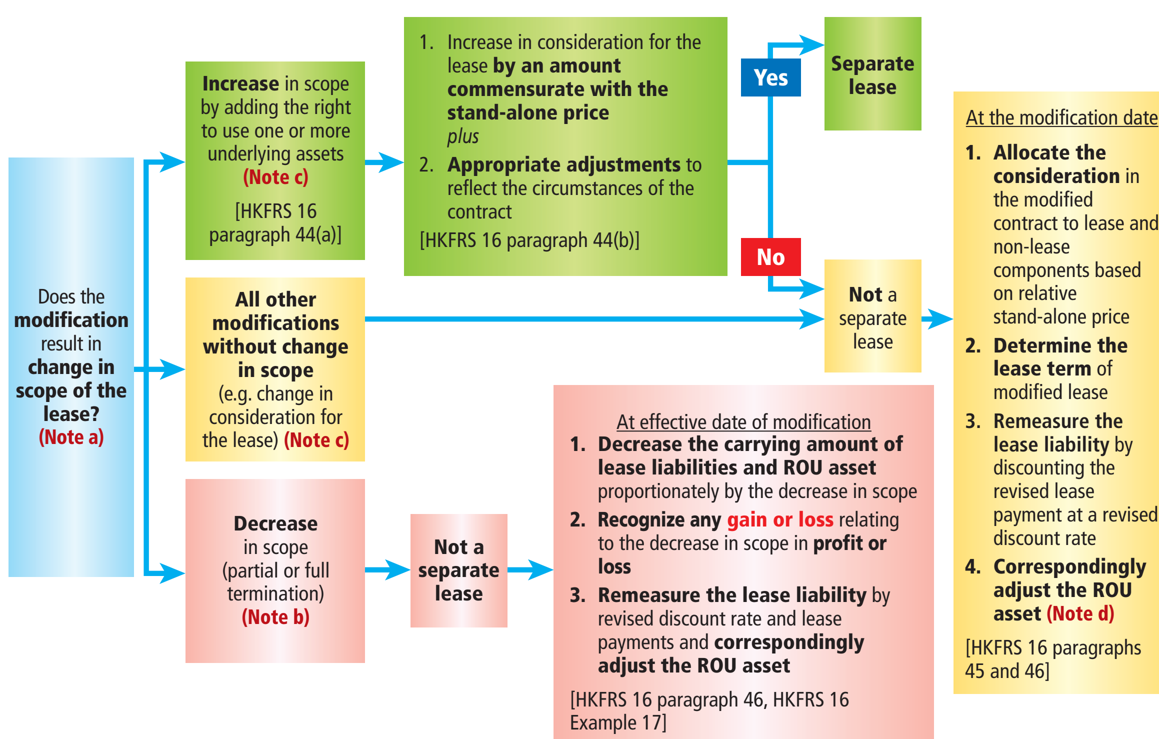
[5] Different accounting requirements applied for "reassessment" and "modification" of a lease. HKFRS 16 paragraphs 39 to 43 set out the requirements for "reassessment of the lease liability".

statements provided no clues about whether there was a corresponding reduction in the group's lease liabilities during the year. Therefore, it was unclear whether the termination was resulted from a lease modification; and if so, whether the relevant requirements under HKFRS 16 paragraphs 44 to 46 had been properly applied to account for the termination.

A "lease modification" is defined as a change in the scope of a lease, or the consideration for a lease, that was not part of the original terms and conditions of the lease – e.g. adding or terminating the right to use or more underlying assets, or extending or shortening the contractual lease term (HKFRS 16 Appendix A). A change that is triggered by a clause that has been included in the original lease contract (e.g. exercise of an option) is not regarded as a lease modification.

HKFRS 16 paragraphs 44 to 46 set out the accounting requirements of lease modification. Different accounting treatments will be applied depending on the nature of the modifications, e.g. whether the modification is considered as a separate lease, and whether the modification increases or decreases the scope of the lease. The following diagram gives an overview of the requirements for accounting of lease modifications under different considerations:

Diagram 7 Lease modification accounting (lessee's perspective)



Note:

a. The effective date of the modification is the date on which the parties agree to the modification of the lease.
b. Examples are termination of the right of use of one or more underlying assets or shortening the contractual lease term.
c. There is an increase in scope only when there is an addition of right to use or more underlying assets to the lease. However, an extension of an existing right, which has an effect of continuation of the existing lease, is still accounted for as lease modification.
d. In circumstances where the corresponding decrease adjustment to the ROU asset (brought by reduction in consideration) is greater than the carrying amount of the ROU asset, the ROU asset is reduced to zero and the difference is recognized in profit or loss.

In response to our enquiry, the auditor of the reporting entity provided more information about the "Termination" relating to the ROU assets. It explained the "Termination" arose from the reporting entity's exercise of an option included in the original lease contracts to acquire some leased motor vehicles by making early payments of the remaining rentals. As the option of early payments was included in the original lease contracts, management did not consider that there was a lease modification. Audit work performed included checking the terms governing the early payments in the lease contracts and inspection of payment supporting documents and registration certificates of the motor vehicles acquired.

Preparers of financial statements should disclose clear information, both qualitative and quantitative, about the leasing activities that is relevant to users of financial statements to assess the effect that leases have on the financial statements of the lessee (HKFRS 16 paragraphs 51 to 60 and B48 to B52). In the above example, it would be useful if the group provided some information in the financial statements about (1) the nature of the leasing activities of the motor vehicles that include the termination option; (2) the future cash flows to which the reporting entity (lessee) was potentially exposed that were not reflected in the measurement of lease liabilities; (3) the fact that the reporting entity exercised the termination option during the year and (4) the management's treatment to account for the "Termination" and the resulting financial impact.

(e) Interactions with other HKFRSs

The adoption of HKFRS 16 has other impacts because of its interactions with other HKFRSs. For instance, as discussed in *note d to Diagram 4* above, an entity that applies the fair value model to its own investment property must apply the fair value model to ROU assets that meet the definition of investment property under HKAS 40 (HKFRS 16 paragraph 34). A lessee can elect whether to account for ROU assets using the revaluation model of HKAS 16 if the leased assets is part of a class of assets to which an entity applies the revaluation model (HKFRS 16 paragraph 35).

Interaction with HKAS 36

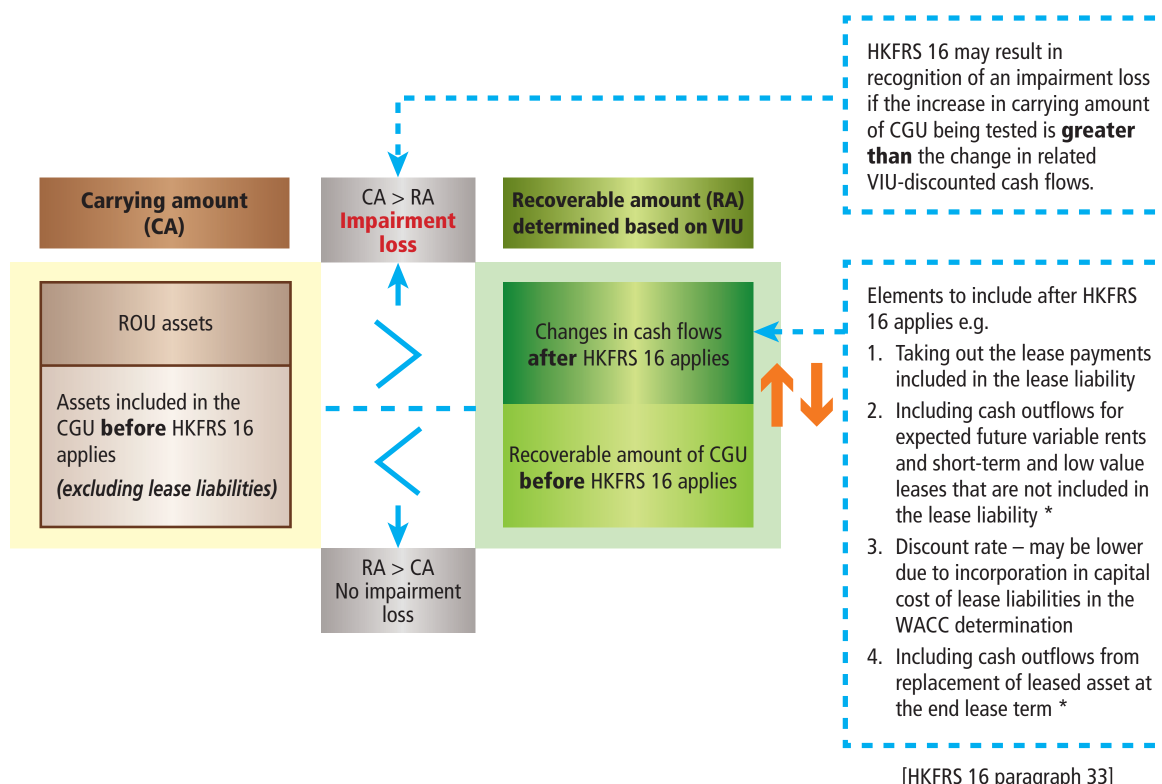
Entities shall follow the requirements of HKAS 36 to measure the recoverable amount of an asset (i.e. the higher of value in use ("VIU") or fair value less cost of disposal ("FVLCOD") if there is an indication of impairment. Typically, unless a ROU asset is subject to a sublease, it does not generate cash inflows that are largely independent from other assets, and therefore should be grouped within a cash-generating unit ("CGU") for impairment assessment.

As a CGU now also includes allocated ROU assets after the adoption of HKFRS 16, it can be envisaged that there will be an increase in the carrying amount of the CGU for impairment assessment as compared to the time before HKFRS 16 was adopted. This impact is shown in *Diagram 8*.

In addition, if a ROU asset is part of CGU that contains goodwill, intangible assets with an indefinite useful life or intangible assets that are not yet ready for use, the lessee shall include the ROU asset as part of the annual impairment test as required by HKAS 36, irrespective of whether the ROU asset itself has any indication of impairment (HKAS 36 paragraphs 10 and 90).

The CGU assets tested under their VIU calculation include ROU assets but exclude related lease liabilities because HKAS 36 paragraph 50(a) specifically exclude all future cash flows from financing activities and lease liabilities are a form of financing. Correspondingly, the expected future cash flows in the VIU calculation also excludes those future lease payments included in the lease liabilities. However, the VIU's expected future cash flows consequent to adoption of HKFRS 16 will include cash flows from short-term and low-value leases and expected future variable lease payments that are not included in the lease liabilities. In short, the recoverable amount of the CGU determined based on VIU calculation post HKFRS 16 would change depending on the effects of (1) the exclusion of lease payments that are included in the lease liability and (2) the continued inclusion of variable lease payments and lease payments relating to short-term and low value leases that are not included in the lease liabilities, as well as other relevant elements as shown in *Diagram 8*.

Diagram 8 Recoverable amount determined based on value in use calculation "after" HKFRS 16 applies



** These two elements are required both before and after HKFRS 16 application.*

The above diagram shows that an entity may come up with a different conclusion on the impairment assessment of a CGU to which ROU assets are allocated as compared to the past assessment prior to adoption of HKFRS 16.

In our 2020 reviews, we encountered cases which we had questions as to whether a proper impairment assessment of ROU assets had been performed by the reporting entities (lessees) under HKAS 36. A set of financial statements reviewed showed that the reporting entity's major assets included ROU assets and property, plant and equipment ("PPE"). The group had recurring losses for a number of years. There was no information to show whether an impairment assessment had been performed on the group's ROU assets and PPE. However, a full impairment was made on the carrying amount of a substantial intangible asset, raising concerns whether the other assets (including the allocated ROU assets and corporate assets[6]) of the same CGU had also been impaired. Impairment assessment of ROU assets and PPE was not regarded as a key audit matter in the auditor's report. It was unclear whether the auditor had performed sufficient appropriate work and obtained sufficient appropriate evidence to ensure that the carrying amount and recoverable amount of the relevant CGU(s) that included ROU assets and/or PPE were properly determined by management for the impairment assessment under HKAS 36.

In addition, the group mentioned in an accounting policy that, when a reasonable and consistent basis of allocation could be identified, corporate assets were allocated to individual CGUs, or otherwise they were allocated to the smallest group of CGUs for which a reasonable and consistent allocation basis could be identified. However, in view of lack of information, it was unclear whether the ROU assets and PPE were corporate assets; and if so, whether the accounting policy was properly applied.

Due to the above, we were concerned whether a proper impairment assessment had been performed by management on ROU assets and PPE; and whether the auditor had performed/obtained sufficient appropriate audit procedures and evidence to satisfy itself that no impairment losses of PPE and ROU assets were required to be recognized. The enquiries with the auditor are in process.

Members are reminded that, after the recognition of an impairment loss, the depreciation of the ROU asset shall be adjusted in future periods to allocate the ROU asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life (HKAS 36 paragraph 63).

(f) Amendment to HKFRS 16 – COVID-19 Related Rent Concessions

Due to the impact of COVID-19 pandemic, many lessors and lessees agreed to various types of rent concessions such as deferrals and/or abatement of rent payments. In view of the anticipated practical difficulties in applying the HKFRS 16 requirements on lease modification to a large volume of COVID-19 related rent concessions, the IASB issued amendments to IFRS 16 which provide relief for lessees in accounting for qualifying COVID-19 related rent concessions. The Institute issued an equivalent amendment to HKFRS 16 ("Amendment to HKFRS 16") in June 2020.

[6] We had discussions on the application of the HKAS 36 requirements concerning the impairment assessment of corporate assets in QAD 2019 annual report:
https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/QA/2020/Quality-Assurance-Report-2019.pdf?la=en&hash=4495DEF7352A523000A65F2043E44F05 (P.66 to P.68)

The Amendment to HKFRS 16 is effective for annual periods beginning on or after 1 June 2020. Earlier application is permitted. If a lessee applies the practical expedient set out in Amendment to HKFRS 16, the lessee does not need to assess whether a rent concession is a lease modification, subject to having met all conditions specified under HKFRS 16 paragraph 46B. That means a lessee can elect to not apply the requirements for lease modification even if the rent concession meets the definition of a lease modification. The practical expedient is not available for lessors.

In a set of financial statements reviewed, the reporting entity disclosed that the group had early adopted Amendment to HKFRS 16 during the year. The disclosure set out the conditions required to be fulfilled before the group, as a lessee, could apply the practical expedient provided in Amendment to HKFRS 16 to elect not to assess whether a rent concession occurring as a direct consequence of the COVID-19 pandemic was a lease modification. However, the following specific disclosures required by Amendment to HKFRS 16 (paragraph 60A) were not found in the financial statements:

"(a) [the fact] that it has applied the practical expedient to all rent concessions that meet the conditions in paragraph 46B or, if not applied to all such rent concessions, information about the nature of the contracts to which it has applied the practical expedient (see paragraph 2); and

(b) the amount recognised in profit or loss for the reporting period to reflect changes in lease payments that arise from rent concessions to which the lessee has applied the practical expedient in paragraph 46A".

We anticipate to see more entities having applied the optional practical expedient under Amendment to HKFRS 16 in our 2021 reviews. Members are advised to refer to the following educational materials published by the Institute which provide illustrative examples on the application of Amendment to HKFRS 16:

- https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/ag_rent.pdf (Examples of COVID-19 related rent concessions)
- https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/06_New-and-major-stds/ie161.pdf (Examples of commonly seen rent concessions in Hong Kong that are not COVID-19 related)

(iii) Lessor accounting

HKFRS 16 does not make substantial changes to lessor accounting as compared to HKAS 17. The only significant change is that subleases must be classified either as finance lease or as operating leases, with reference to the ROU asset resulting from the head lease (HKFRS 16 paragraph B58). Accordingly, a lessor is required to continue to assess and identify whether leases are a finance or an operating lease and account for these types of leases differently (HKFRS 16 IN14).

No observations were identified in respect of the accounting for leases by lessors from our reviews in 2020.

3. Disclosure deficiencies

Under HKFRS 16, lessees will need to apply judgement in deciding upon the information to disclose to meet the objective of providing a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lease. For lessors, HKFRS 16 requires enhanced disclosures about the lessor's risk exposure, particularly to residual value risk.

Save for those discussed in the above, the following list provides a summary of some other commonly omitted disclosures required by HKFRS 16 (mainly on lessees):

<u>For lessee</u>

- the amounts required by HKFRS 16 paragraph 53[7] for the reporting period, e.g.:

  (i) depreciation charge for right-of-use assets by class of underlying asset (HKFRS 16 paragraph 53(a));

  (ii) the interest expense on lease liabilities (HKFRS 16 paragraph 53(b));

  (iii) the expense relating to short-term leases accounted for applying paragraph 6 (HKFRS 16 paragraph 53(c)[8]);

  (iv) the expense relating to leases of low-value assets accounted for applying paragraph 6 (HKFRS 16 paragraph 53(d));

  (v) total cash outflow for leases (HKFRS 16 paragraph 53(g));

  (vi) additions to right-of-use assets (HKFRS 16 paragraph 53(h)); and

  (vii) the carrying amount of right-of-use assets at the end of the reporting period <u>by class of underlying asset</u> (underline added) (HKFRS 16 paragraph 53(j)).

  In respect of (vii) above, a reporting entity engaged in a shipping port business showed in its financial statements "Concession" was included in the carrying amount of the ROU assets. The Management Discussion and Analysis Section ("MD&A") of the annual report mentioned that the concession arrangements included operations and utilization of piers for certain number of years granted by a port authority.

  Considering the significance of the carrying amount of "Concession", we expect that appropriate details of the lease arrangements such as information on the nature of the underlying assets (e.g. the major items of pier facilities) should have been disclosed to facilitate users of financial statements to assess the effect that leases have on the financial statements with regard to the nature of the group's business.

[7] HKFRS 16 paragraph 54 that *"A lessee shall provide the disclosures specified in paragraph 53 <u>in a tabular format</u>, unless another format is more appropriate"* (underline added).

[8] HKFRS 16 paragraph 55 requires that *"A lessee shall disclose the amount of its lease commitments for short-term leases accounted for applying paragraph 6 if the portfolio of short-term leases to which it is committed at the end of the reporting period is dissimilar to the portfolio of short-term leases to which the short-term lease expense disclosed applying paragraph 53(c) relates"*.

- a maturity analysis of lease liabilities applying HKFRS 7 *Financial Instruments: Disclosures* paragraphs 39 and B11 separately from the maturity analyses of other financial liabilities (HKFRS 16 paragraph 58).

- additional qualitative and quantitative information required by HKFRS 16 paragraph 59 about reporting entities' leasing activities necessary to meet the disclosure objective in HKFRS 16 paragraph 51 including:

  (i) the nature of the lessee's leasing activities (HKFRS 16 paragraph 59(a));

  (ii) future cash outflows exposure arising from extension options and termination options to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities (HKFRS 16 paragraph 59(b)(ii)); and

  (iii) restrictions or covenants imposed by leases (HKFRS 16 paragraph 59(c)).

- information about initial application of HKFRS 16 (HKFRS 16 paragraph C12), e.g. :

  (i) the weighted average lessee's incremental borrowing rate applied to lease liabilities recognized in the statement of financial position at the date of initial application (HKFRS 16 paragraph C12(a)); and

  (ii) an explanation of any difference between operating lease commitments disclosed applying HKAS 17 at the end of the annual reporting period immediately preceding the date of initial application, discounted using the incremental borrowing rate at the date of initial application as described in HKFRS 16 paragraph C8(a); and lease liabilities recognized in the statement of financial position at the date of initial application (HKFRS 16 paragraph C12(b)(i) and (ii)).

Apart from the above omitted disclosures, we observed that some reporting entities did not properly present cash flows arising from the leasing activities in their consolidated statement of cash flows as required by HKFRS 16 paragraph 50[9], e.g. cash payments for the principal portion of the lease liabilities were not included within financing activities.

[9] The IASB decided that a lessee should classify the principal portion of cash repayments of the lease liability as financing activities in the statement of cash flows and classify cash payments relating to interest consistently with other interest payments. This approach is consistent with the requirements in IAS 7 *Statement of Cash Flows* for cash flows relating to financial liabilities and provides comparability between interest paid on leases and interest paid on other financial liabilities (HKFRS 16 BC211).

For lessor

- for finance leases, a maturity analysis of the lease payments receivable, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years (HKFRS 16 paragraph 94); and

- for operating leases, a maturity analysis of lease payments, showing the undiscounted lease payments to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years (HKFRS 16 paragraph 97).

HKFRS 16 is a comprehensive standard which bring in a lot of changes to concepts and requirements in the accounting for leases. This report only highlights some key concepts and issues in the application of HKFRS 16 identified based on our reviews and therefore they are not exhaustive. There are many other detailed requirements across different aspects set out in HKFRS 16. Accordingly, we advise our members to read HKFRS 16 in full in order to gain adequate understanding of the Standard. The Institute has developed dedicated resource webpage[10] on major Standards including HKFRS 16 to assist members in understanding and applying HKFRS 16. Application of HKFRS 16 and other major standards (e.g. HKFRS 9 and HKFRS 15 as discussed in Section II) will continue to be our focus in future reviews. We would share with members the application issues or pitfalls at appropriate time.

[10] The webpage can be accessed at:
https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/New-and-major-standards/New-and-Major-Standards

Section II – Significant or common application issues of other financial reporting standards

In this part of the report, we shall share with you the issues identified from our reviews on application of the following major recurring financial reporting standards:

- HKFRS 9 (2014) *Financial Instruments*;
- HKFRS 15 *Revenue from Contracts with Customers*; and
- HKFRS 10 *Consolidated Financial Statements*.

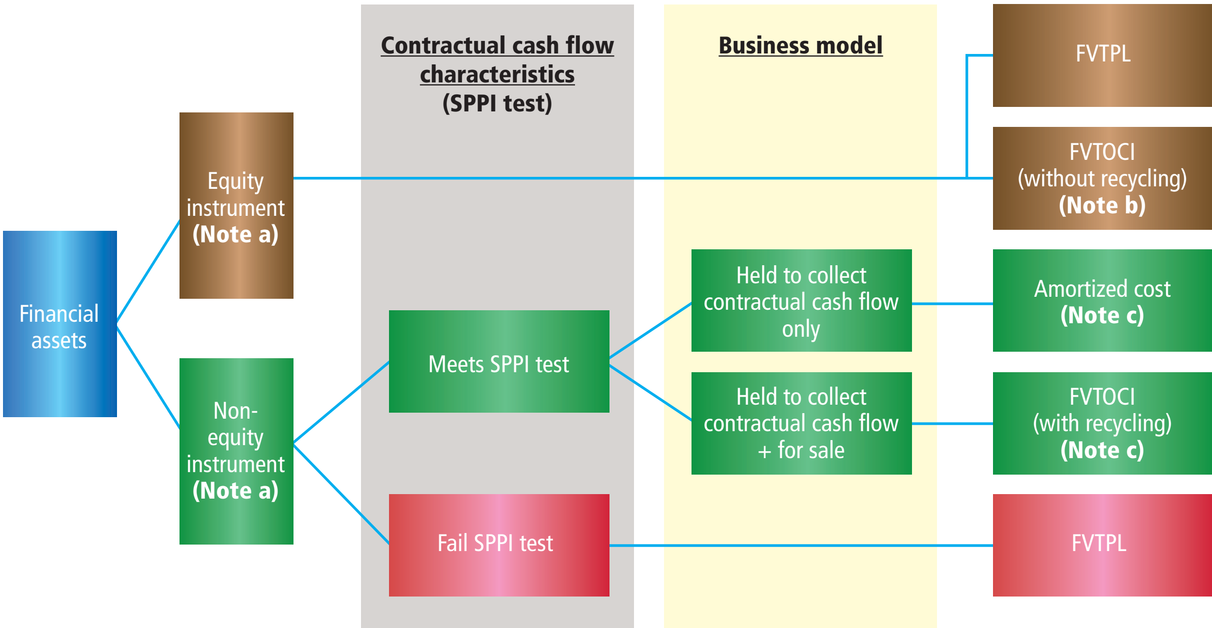
1. HKFRS 9 (2014) *Financial Instruments*

This is our second year of reviewing the implementation of HKFRS 9 (2014) under the PSM programme. We discussed some basic concepts and key requirements of HKFRS 9 (2014) concerning (A) the classification and measurement of financial instruments and (B) impairment assessment of financial assets in our QAD 2019 annual report. This Section continues to share with members the application issues on these two aspects based on our reviews carried out in 2020.

(A) Classification of financial instruments

This diagram was provided in our QAD 2019 annual report. We reproduce it here below to facilitate our illustration of the issues concerning classification of a financial instrument.

Diagram 9 Classification and measurement of financial assets



Note:

a. Equity instrument cannot pass the SPPI test. Only debt instrument can pass.

b. The FVTOCI option without recycling is only available for equity instrument that is not held for trading. It is an irrevocable option made at initial recognition (HKFRS 9 paragraph 5.7.5).

c. A financial asset can be designated and measured at fair value through profit or loss if the fair value option is applied (HKFRS 9 (2014) paragraph 4.1.5)

Under HKFRS 9 (2014), on initial recognition, a financial asset is classified into one of the following three measurement categories:

- Amortized cost;
- Fair value through other comprehensive income ("FVTOCI"); or
- Fair value through profit or loss ("FVTPL").

As shown in *Diagram 9*, after determining whether a financial asset is an equity instrument or not, there are further requirements to be considered before determining such financial asset falls into which of the above three measurement categories. Issues were identified in respect of application of those requirements.

(i) Non-equity instruments

(a) Accounting for bill receivables – business model assessment

The business model assessment is one of the two steps to determine how a financial asset that is not an equity instrument should be classified. An entity's business model refers to how the entity manages its financial assets in order to generate cash flows. Such business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. The table below sets out some key reminder points in the business model assessment:

Diagram 10 Key reminder points in the business model assessment

Some key concepts and reminders	Ref
At which level the business model assessment to be performed? ✓ An entity's business model is determined **at a level that reflects how groups of financial assets are managed together to achieve a particular business objective**. The entity's business model does not depend on management's intentions for an individual instrument, but at a higher level of aggregation **(Note a)**.	HKFRS 9 (2014) paragraph B4.1.1
Will there be any impact on a financial asset's classification if the subsequent cash flows no longer be in line with the initial business model assessment? ✓ Classification of a financial asset is determined in accordance with the business model in place **at the time of initial recognition**. Therefore, if cash flows are realized in a way that is different from the entity's expectations at the date, **this does not give rise to a prior period error in the entity's financial assessment nor change the classification of remaining financial assets held in that business model**. However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realized in the past, along with all other relevant information.	HKFRS 9 (2014) paragraph B4.1.2A
What is the basis of the business model assessment? ✓ The business model assessment should be performed based on consideration of all facts and circumstances, with an analysis of past sale and expectation of future sales of financial asset. ✓ The business model assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called "worst case" or "stress case" scenario. ✓ Judgement may need to be applied in the assessment.	HKFRS 9 (2014) paragraphs B4.1.2A and B4.1.2B

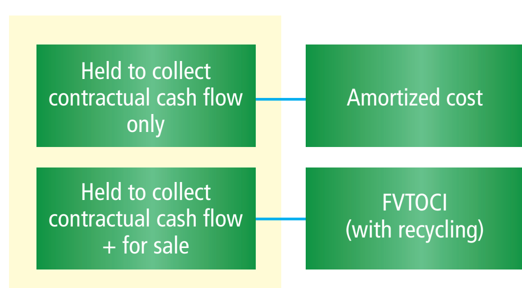
Note:

a. Classification need not be determined at the reporting entity level. The assessment should reflect the way how an entity manages its financial instrument. A single entity may have more than one business model for managing its financial instruments (HKFRS 9 (2014) paragraph B4.1.2).

A reporting entity's financial statements showed that the group had significant bill receivables which were all accounted for at amortized cost at the year end. However, we found that interest expenses on discounted bills were recognized in the current and past years.

Based on information disclosed, the group appeared to have a practice to discount its bill receivables for financing its operations or other purposes. There was no information of the terms of the bills discounted (e.g. on a recourse basis or not) provided in the financial statements. Questions therefore arose as to whether the group had a business model whose objective was to be achieved by both collecting contractual cash flows and selling the relevant financial assets; and if so, whether any bill receivables outstanding at the year end held under this business model should have been accounted for at FVTOCI as required by HKFRS 9 (2014) paragraph 4.1.2A instead of at amortized cost. Accordingly, an enquiry was raised with the auditor to ask them to provide information about the bill receivables and key terms of discounted bills; and explain how the management performed the business model assessment as required by HKFRS 9 (2014) in order to support the conclusion that it was appropriate to classify and account for all the group's bill receivables at amortized cost.

Extract 1 of Diagram 9



As shown in *Extract 1 of Diagram 9*, there are two distinct business models of which one whose objective is "to hold assets in order to collect contractual cash flows" and the other whose objective is "achieved by both collecting contractual cash flows and selling financial assets". As compared to the first business model, the second one typically involves greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it[11]. Members may refer to HKFRS 9 (2014) paragraphs B4.1.2C to B4.1.4B for further guidance.

In response to our enquiry, the auditor clarified that the group only had a few bill receivables having been discounted to banks due to unanticipated funding needs. The response also explained that, after considering the reasons and frequency of the discounting transactions, management was of the view that the discounting transactions were only an incidental part of the group's business model and hence should not have had an impact on the "amortized cost" classification under the "held to collect contractual cash flows only" business model.

HKFRS 9 (2014) paragraph B4.1.4 provides examples of when the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows. The auditor's explanation appears to be consistent with Example 1 provided under HKFRS 9 (2014) paragraph B4.1.4 which explains that infrequent sales resulting from unanticipated funding needs (e.g. in a stress case scenario) would not contradict that objective, even such sales are significant in value.

[11] There is no threshold for the frequency or value of sales that must occur in this business model because both collecting contractual cash flows and selling financial assets are integral to achieving its objective (HKFRS 9 (2014) paragraph B4.1.4B).

Impact of factoring on the business model assessment

Factoring of trade or bill receivables to another party (e.g. banks) is one of the common methods used by entities to obtain financing. The factoring arrangement might or might not result in derecognition of the receivables depending on the terms and conditions of the arrangement. However, if a derecogniton takes place because the transfer of the contractual rights to receive a financial asset's cash flows meets the notion of a "sale", such financial asset is regarded as "sale" for the purpose of HKFRS 9's business model assessment.

On the other hand, if an entity retains substantially all the risks and rewards of the financial asset after the transfer and hence continues to recognize the transferred financial asset on its statement of financial position under HKFRS 9 (2014), further analyses based on facts and circumstances should be performed to determine whether the sale of the asset meets the notion of "sale" when applying the business model assessment. An accounting policy should be developed in order to consistently account for those financial assets.

For example, in a "repo" transaction (i.e. the entity sells an asset but at the same time agrees to repurchase it at an agreed price at a later date before maturity), it may be reasonable for the entity, which continues to recognize the financial asset on its statement of financial position at the date of transfer, to reach a conclusion that its business objective is to collect the contractual cash flows on its asset given that the legal transfer of the asset to the transferee is only temporary and the entity intends to collect cash flows from the asset following maturity of the repo.

The accounting policy for classification of financial assets and the significant judgement applied by management in applying the policy should be clearly and adequately disclosed as required by HKAS 1. Therefore, when an entity enters into factoring arrangements which would result in transfers of significant financial assets, we consider that it should disclose clearly in its accounting policy the key factors to be considered by management with respect to the factoring arrangements that would affect the business model assessment as well as the significant judgement applied based on facts and circumstances.

(b) Accounting for listed debt investments

A reporting entity disclosed in its financial statements that the group's investments measured at FVTOCI at the year end included both equity investments and debt investments, which were both designated to be measured at FVTOCI on initial recognition.

By referring to *footnote b to Diagram 9*, the irrevocable election at initial recognition to designate a financial instrument to subsequently be measured at FVTOCI only applies to equity investments[12] but not to debt investments (HKFRS 9 (2014) paragraphs 4.1.4 and 5.7.5). In this example, in order to measure the debt investments at FVTOCI (see *Extract 1 of Diagram 9*), the debt investments needed to pass the contractual cash flow characteristic test (i.e. SPPI test) and be justified in the business model test that they were held within a business model whose objective was to both collect the contractual cash flows from the assets and sale of the investments. A debt instrument can never be "designated" to be measured at FVTOCI. A debt instrument also cannot be accounted for at FVTOCI (with recycling) without going through the SPPI test and the business model test.

Although the changes in fair value in an equity investment and a debt investment measured at FVTOCI are both presented in OCI, members should note the following important differences in their accounting treatments:

Diagram 11 Differences in accounting treatment between an equity investment at FVTOCI and debt investment at FVTOCI

Equity investment at FVTOCI	Debt investment at FVTOCI
✓ On derecognition, gains and losses previously recognized in OCI **not to be reclassified to profit or loss** [HKFRS 9 (2014) paragraphs B5.7.1 & BC5.25(b)]	✓ On derecognition, cumulative gains and losses in OCI **reclassified to profit or loss** ✓ The amounts that are recognized in profit or loss are the same as the amounts that would have been recognized in profit or loss if the financial asset had been measured at amortized cost [HKFRS 9 (2014) paragraphs 5.7.10 & 5.7.11]
✓ **No impairment loss** recognized in profit or loss [HKFRS 9 (2014) paragraph 5.5.1]	✓ Subject to the **same impairment loss model as those measured at amortized cost** ✓ When calculating the expected credit loss ("ECL"), movements in ECL allowance are recognized in profit or loss with corresponding same amount of loss allowance recognized in OCI ✓ The carrying amount of the financial asset in the statement of financial position, which is measured at FV, is not reduced by a loss allowance. An entity shall not present the loss allowance separately in the statement of financial position as a reduction of the carrying amount of the financial asset ✓ **Disclose the accumulated loss allowance** in the notes to the financial statements [HKFRS 9 (2014) paragraphs 5.5.1 & 5.5.2] [Example 13 set out in HKFRS 9 (2014) IE78 to IE81] [HKFRS 7 paragraph 16A]

[12] The election can be made on an instrument-by-instrument basis (HKFRS 9 (2014) paragraph B5.7.1).

(c) Accounting for structured deposits – SPPI test

It is not uncommon that entities enter into structured deposit contracts with banks in order to earn a higher investment return. The structured deposit contracts may contain terms and features which affect the timing and amount of the returns (e.g. interest income) to be received by the investor. As structured deposits are generally not equity instruments, questions would arise as to whether those terms and features set out in the structured deposit contracts, which contain features more than simple bank deposits, still pass the SPPI test. Careful assessment of those contractual terms and features are particularly important as the conclusion reached will affect the classification and measurement of the structured deposits.

In one example, the reporting entity's structured deposits at 31 December 2019 were classified into "Financial assets at amortized cost" and "Financial assets at FVTPL". By tracing to earlier financial statements, we found that the reporting entity reclassified all its structured deposits from "prepayments, other receivables and other assets" which were previously measured at amortized cost to financial assets at FVTPL on initial application of HKFRS 9 (2014) in 2018 because the structured deposits did not pass the SPPI test. Given that the other parts of the 2018 and 2019 annual reports of the reporting entity provided the same description of the nature of the group's structured deposits (e.g. investment products issued by commercial banks), it was unclear about the management's consideration given in 2019 before determining that some of the structured deposits in 2019 had met the SPPI test and hence classifying them as financial assets measured at amortized cost.

The "SPPI test" refers to an assessment performed by an entity on whether the contractual cash flows arising from the financial asset represent, on specified dates, solely payments of principal amount and interest on the principal amount outstanding which are consistent with a basic lending arrangement. A financial asset that meets the SPPI test may be accounted for at amortized cost or FVTOCI (with recycling) depending on the business model assessment (see *Diagram 9*). Therefore, a financial asset that does not meet the SPPI test is always measured at FVTPL, unless it is an equity instrument and that the entity applies the irrevocable OCI option (HKFRS 9 (2014) paragraphs 4.1.2, 4.1.2A, 4.1.4 and 5.7.5).

In response to our enquiry, the auditor explained that the reporting entity's major structured deposits at the 2019 year end were structured deposits entered into with some banks and the return rates were linked to certain commodity market indexes. The structured deposit contracts specified a return rate ("1st return rate") if the fluctuation of the designated market index fell within a certain range and another return rate ("2nd return rate") if the fluctuation fell outside the range. Based on the historical records of the market index, the management considered that the contract term of the 2nd return rate was "not genuine" as the occurrence of the specified event (i.e. market index falling outside the range) would be extremely rare, highly abnormal and very unlikely to occur.

HKFRS 9 (2014) paragraph B4.1.18 states that a contractual cash flow characteristic does not affect the classification of the financial asset if (1) it could have only "a de minimis effect on the contractual cash flows" or (2) it could have an effect that is "more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine". That means, the contractual features which are "not genuine" or have only a de minimis impact on the contractual cash flows can be disregarded in the SPPI assessment. "Non- genuine" contractual features are generally considered as contractual features that do not have commercial substance.

The auditor's response showed that the management had applied the above exception provided in HKFRS 9 (2014) paragraph B4.1.18 to support its conclusion that the contract term of the 2nd return rate was "not genuine" and therefore could be disregarded resulting in only one fixed return rate (i.e. the 1st return rate) and the relevant structured deposits passing the SPPI test.

However, it is questionable why the banks and the reporting entity entered into a contract term that did not have commercial substance or for no economic purpose or consequence. In addition, HKFRS 9 (2014) paragraph B4.1.7A explicitly states that contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding (i.e. not passing the SPPI test). Accordingly, a closer look at the matter is needed in order to ascertain that the SPPI test was met and the matter is under enquiry.

A learning point here is that, in performing the SPPI assessment, members should watch out for contractual features that may change the timing or amount of contractual cash flows. Such assessment should include an understanding of the nature of any contingent event covered by the contract terms. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are SPPI, it may be an indicator (HKFRS 9 (2014) paragraph B4.1.10). HKFRS 9 (2014) paragraph B4.1.11 provides examples of contractual terms that result in contractual cash flows that are SPPI.

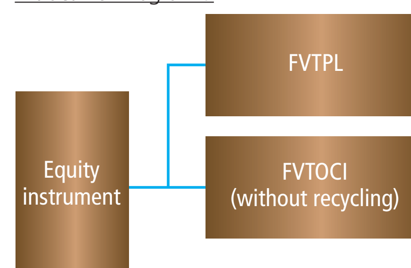
(ii) Equity instruments

The following sets out some examples that suggested that the reporting entities might not have adequately considered the requirements under HKFRS 9 (2014) in order to properly classify and measure its investments.

(a) A set of financial statements disclosed that the reporting entity accounted for its investments in "equity securities listed in Hong Kong" at FVTOCI. The disclosure mentioned that these investments were held for trading and also for long-term strategic purpose. It was unclear why a held for trading investment could, at the same time, achieve "long-term" strategic purposes.

Nevertheless, as stated in *footnote b to Diagram 9*, a held for trading equity investment cannot be measured at FVTOCI but is instead required to be measured at FVTPL under HKFRS 9 (2014) paragraph 5.7.5. Therefore, the reporting entity's accounting for its held for trading equity securities listed in Hong Kong at FVTOCI had departed from the HKFRS 9 (2014) paragraph 5.7.5 requirement.

Extract 2 of Diagram 9



(b) A reporting entity's equity investments measured at FVTOCI included "unlisted investment funds at fair value". The disclosure only mentioned that their fair value was determined by reference to the quotation provided by the fund manager of the investment funds at the reporting date. There was no further disclosure of any information about the nature and components of the underlying investments in those funds. Therefore, it was unclear, firstly, why the investment funds were assessed as "equity instruments"; and secondly, whether the funds had met the circumstances set out in HKFRS 9 (2014) paragraph 5.7.5 in order to support them being measured at FVTOCI.

Should the investment funds fail to meet the definition of an "equity instrument" under HKAS 32 *Financial Instruments: Presentation* paragraph 11 and hence they are not "equity investments", the investment funds would have required to satisfy both two conditions set out in HKFRS 9 paragraph 4.1.2A (i.e. the SPPI test and business model whose objective is achieved by both collecting contractual cash flow and selling the financial asset) just like those examples discussed earlier in this Section in order for them to be measured at FVTOCI.

Considering the potential continued effect of the above issue on the reporting entity's future financial statements, we had correspondence with the auditor drawing their attention to the issue and our concerns. The auditor was also asked to advise client management to ensure that sufficient disclosures (e.g. the nature of the investments and management's basis) are provided to support the classification of those investment funds as FVTOCI.

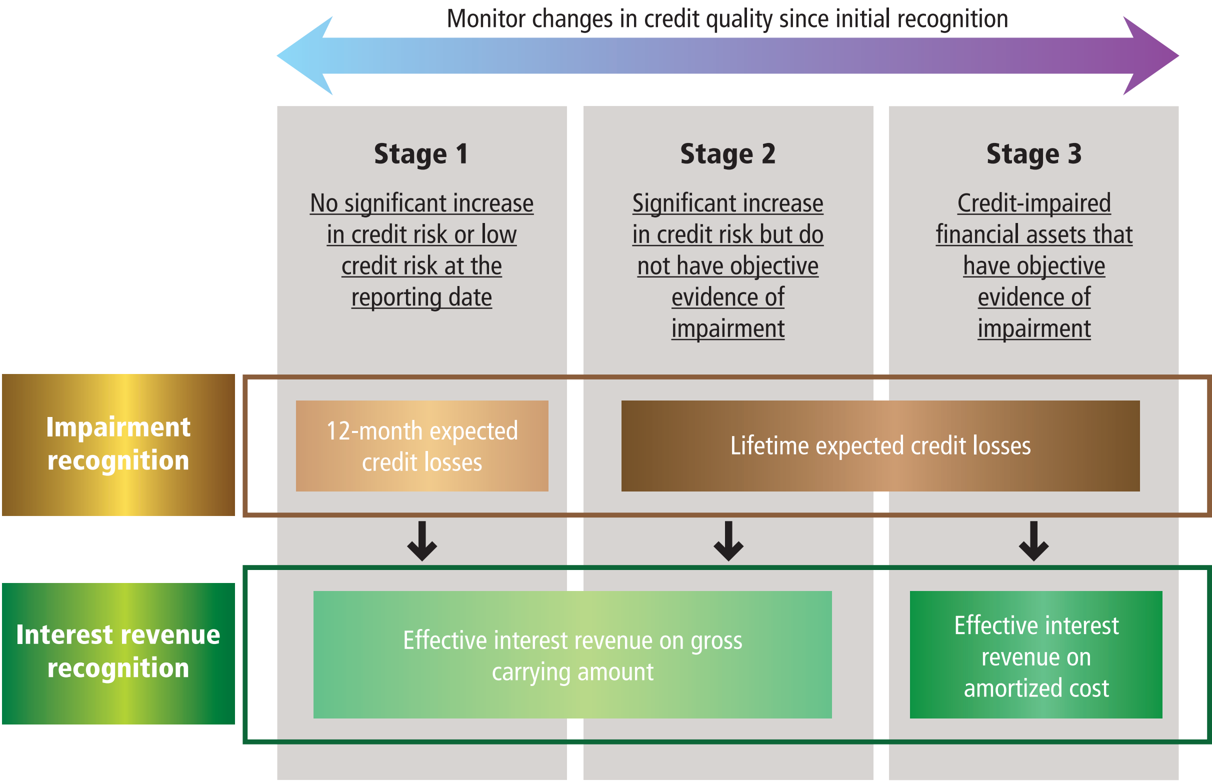
(B) Impairment of financial assets

HKFRS 9 (2014) requires an expected credit loss ("ECL") model to be used for recognition and measurement of impairment in financial assets that are measured at amortized cost or FVTOCI except for equity instruments designated at FVTOCI. This is the only impairment loss model required under HKFRS 9 (2014) because all other assets are classified and measured at FVTPL. Under the expected loss model, it is no longer necessary for a credit loss event to have occurred before recognizing a credit loss.

The three approaches under HKFRS 9 (2014) for impairment assessment are (1) simplified approach[13], (2) general approach and (3) purchase or originated credit-impaired approach. We discussed the key different requirements of the three approaches in our QAD 2019 annual report. In particular, under the *general approach*, there are three stages of ECL assessment carried out based on monitoring of changes in credit risk of the financial asset since initial recognition.

The following diagram provided in our QAD 2019 annual report summarizes the general approach under HKFRS 9 (2014):

<u>Diagram 12 General approach for impairment assessment</u>



[13] In respect of the applicability of the *simplified approach* under HKFRS 9 (2014) paragraph 5.5.15:

1) The *simplified approach* is <u>required to be used</u> for trade receivables or contract assets that result from transactions within the scope of HKFRS 15 and that do not contain a significant financing component (or when the entity applies the practical expedient for contracts that are one year or less);
2) An entity has <u>an accounting policy choice</u> to apply either the *simplified approach* or the *general approach* separately to trade receivables or contract assets that result from transactions within the scope of HKFRS 15 and that contain a significant financing component, or lease receivables that result from transactions within HKFRS 16.

The common issues identified concern mostly whether management had performed proper credit risk assessment in the three-stage general approach; whether the default rates were appropriately determined; and whether an appropriate approach (e.g. the simplified approach or general approach) had been applied to determine the ECL. Some of the deficiencies reported in our QAD 2019 annual report were continued to be identified in our 2020 reviews. The more common or significant deficiencies are summarized and discussed below:

(a) Monitoring changes in credit risk since initial recognition

Under the general approach, if a financial asset is assessed to have a significant increase in credit risk since initial recognition, the ECL assessment shall fall into Stage 2 of the ECL model where the lifetime ECL should be calculated.

Under HKFRS 9 (2014), it is presumed that there has been a significant increase in credit risk since initial recognition when the contractual payments of a financial asset are 30 days past due (HKFRS 9 (2014) paragraph 5.5.11) and that later on the financial asset is considered to be in default if it is 90 days past due (HKFRS 9 (2014) paragraph B5.5.37)[14] , although both presumptions are rebuttable.

The following instances raised doubts whether the reporting entities had applied the requirements of HKFRS 9 (2014) properly to monitor the changes in credit risk of a financial asset as part of the impairment assessment under the general approach. Since the instances identified related to different parts of the ECL model under HKFRS 9 (2014), we group those similar together and present them in a tabular form to facilitate members' understanding of the issues and the related implications:

Background	Issues identified
Example 1 A reporting entity's accounting policy included a presumption that the credit risk of a financial asset had increased significantly since initial recognition when contractual payments were more than 360 days past due. The accounting policy also stated that default had occurred when a financial asset was more than 360 days past due unless the group had reasonable and supportable information to demonstrate that a more lagging default criterion was more appropriate.	1) Applying the same benchmark (i.e. 360 days past due) to identify when there had been a significant increase in credit risk and when a default had occurred raised doubts whether the group had confusion between the "significant increase in credit risk since initial recognition" and "default has occurred" under HKFRS 9 (2014). This suggested that the 3-stage model of the general approach might have been inappropriately applied. 2) There was no disclosure of the reasons for setting the default criterion as "360 days past due" as required by HKFRS 7 *Financial Instruments: Disclosures*. It was unclear how it was justifiable to revoke the "30 days past due" and "90 days past due" presumptions set out in HKFRS 9 (2014) paragraphs 5.5.11 and B5.5.37, respectively.

[14] The assessment of whether lifetime ECL should be recognised is based on significant increases in the likelihood or risk of a **default** occurring since initial recognition (irrespective of whether a financial instrument has been repriced to reflect an increase in credit risk) instead of on evidence of a financial asset being credit-impaired at the reporting date or an actual default occurring. Generally, there will be a significant increase in credit risk **before** a financial asset becomes credit-impaired or an actual default occurs (HKFRS 9 (2014) paragraph B5.5.7).

An entity cannot align the timing of significant increases in credit risk and the recognition of lifetime expected credit losses to when a financial asset is regarded as credit-impaired or an entity's internal definition of default (HKFRS 9 (2014) paragraph B5.5.21).

Background	Issues identified
Example 2 The accounting policy of a reporting entity stated that, for all financial instruments other than trade receivables, the group measured the ECL allowance equal to 12-month ECL, unless there had been a significant increase in credit risk since initial recognition. The disclosure mentioned that the group's definition of default was "90 days past due". The group recognized the ECL allowance for trade receivables and other receivables but none for its bill receivables. There was no information to explain the group's credit risk assessment of its bill receivables and why no loss allowance was required to be recognized at the year end. Similar instances were also found in other reporting entities concerning credit risk assessment of bill receivables and other receivables (e.g. loan advances) and their past due status as there was no relevant information disclosed in the financial statements. No ECL allowance was recognized on these balances, even though they were financial assets measured at amortized cost and needed to be subject to an ECL assessment under HKFRS 9 (2014). It is questionable whether those entities only focused on performing the ECL assessment for trade receivables.	The lack of appropriate disclosures of the ECL assessment of bill receivables and other receivables and non-recognition of any ECL allowance for these receivables: 1) raised doubts whether the management had properly applied the 3-stage ECL model to assess changes in credit risk of the bill receivables and other receivables since initial recognition to determine the ECL; and 2) raised concerns whether there was a potential non-compliance with HKFRS 9 (2014) paragraph 5.5.1 which requires an entity to recognize an ECL allowance on a financial asset that is measured in accordance with paragraphs 4.1.2 (at amortized cost) or 4.1.2A (i.e. at FVTOCI).
Example 3 A reporting entity's loan to a related party had been outstanding for a number of years although the loan had been renewed annually. An impairment loss was provided on half of the gross carrying amount of the loan balance in last year. In the current year, the group determined the ECL of the loan based on the 12-month ECL assessment.	The ECL determined based on 12-month ECL suggested that the management considered that there had been no significant increase in credit risk since initial recognition (HKFRS 9 (2014) paragraph 5.5.5) or determined that the loan to have low credit risk at the reporting date (i.e. Stage 1 of the 3-stage ECL model under the general approach). However, the fact that an impairment loss having been provided on more than 50% of the gross carrying amount of a very long-outstanding loan balance in last year was an indication of an increase in credit risk of the loan due from the related party or even an indication of the loan having been credit impaired. A robust analysis of the credit risk changes of the balance[15] should be performed to assess whether ECL allowance should be determined based on lifetime ECL (i.e. Stage 2 or Stage 3 of the ECL model) instead of 12-month ECL. In the assessment, the entity should assess whether the loan met the criterion of credit impaired as defined in HKFRS 9 (2014) Appendix A.

Members are reminded that the assessment of significant increase in credit risk is distinct from the measurement of ECL. For example, a collateralized financial asset may have suffered a significant increase in credit risk but due to the increase in value of the collateral there may not be a need to increase the amount of ECL even if the ECL is measured on a lifetime (i.e. Stage 2 or 3 under the general approach) and not a 12-month basis (i.e. Stage 1).

[15] In respect of how an ongoing review of significant increase in credit risk should be performed, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. To make that assessment, an entity shall compare the risk of a default occurring on the financial instrument as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition and consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk since initial recognition (HKFRS 9 (2014) paragraph 5.5.9).

(b) Other application issues

Background	Issues identified
Applicability of the simplified approach Some reporting entities stated in their accounting policy for impairment assessment of financial assets that the financial assets for which the simplified approach under HKFRS 9 (2014) were used included other receivables and bill receivables.	HKFRS 9 (2014) paragraph 5.5.15 specifies that the simplified approach can only be applied for trade receivables, contract assets and lease receivables[16]. Without further information of the other receivables and bill receivables, it is questionable whether it is justifiable to apply the simplified approach to those receivables.
Determination of expected loss rate Some reporting entities disclosed their provision matrix showing the ageing analysis of past due trade receivables and the expected loss rate applied to the respective ageing categories for ECL determination. However, an expected loss rate of 0% was determined for the more recent past due trade receivables and very low rate (less than 1%) for the other long past due trade receivables. It was unclear how the use of 0% and the very low expected loss rates was justifiable with regard to the credit risk of trade receivables of different customers. Multiple instances were identified where there was no information to show whether forward-looking information had been duly incorporated in the determination of the expected loss rate.	1) The non-recognition of an ECL allowance was potential non-compliance with HKFRS 9 (2014) paragraph 5.5.1 which requires an entity to recognize an ECL allowance on a financial asset that is measured in accordance with paragraphs 4.1.2 (at amortized cost) or 4.1.2A (i.e. at FVTOCI). In particular, HKFRS 9 (2014) paragraph B5.5.28 states that the expected credit losses are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due. 2) There was a lack of disclosures (e.g. the relevant basis and assumptions and how the forward-looking information had been incorporated into the ECL determination) required by HKFRS 7.

HKFRS 9 (2014) paragraph B5.5.35 provides the practical expedient to calculate ECLs on trade receivables using a provision matrix. For example, a provision matrix may specify some fixed provision rates depending on the number of days past due (e.g. 1% if not past due, 2% if less than 30 days past due, etc.). Appropriate groupings of customer bases (e.g. based on geographical region, product type, customer rating, collateral or trade credit insurance and type of customers (such as wholesale or retail)) can be used if the historical credit loss experience shows significantly different loss patterns for different customer segments. In light of the wide-ranging impact of COVID-19 pandemic, entities should take into account available forward-looking information to reassess whether their previous groupings are still appropriate or relevant.

[16] See footnote 13 above.

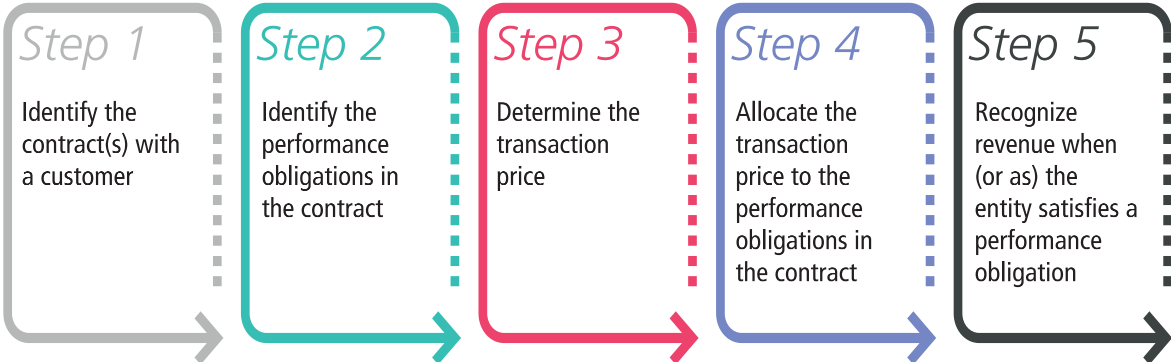
The impairment model under HKFRS 9 (2014) is forward-looking and takes into account all reasonable and supportable information available with respect to ECL. The expected loss rate is determined based on historical observed loss rates over the expected life of the financial asset and is adjusted for forward-looking estimates. At every reporting date, the historical observed rate are updated and changes in the forward-looking estimates are analyzed. Members may refer to the example provided in HKFRS 9 (2014) paragraphs IE74 to IE77 which illustrates the use of a provision matrix.

We expect auditors to perform sufficient appropriate audit procedures and obtain sufficient appropriate audit evidence to assess the appropriateness of ECL determination by management, including the appropriateness of the expected loss rates and groupings of customers. Auditors should maintain a questioning mind to critically challenge the management's explanation and justification. Please refer to "Our findings – practice review programme" for the common or significant audit deficiencies identified during our practice reviews.

2. HKFRS 15 *Revenue from Contracts with Customers*

HKFRS 15 is another major HKFRS with the same effective date as HKFRS 9 (2014), i.e. mandatory to be applied for financial statements with annual periods beginning on or after 1 January 2018. The five-step model in HKFRS 15 applies to revenue earned from a contract with a customer (with limited exceptions[17]) regardless of the type of revenue transaction or the industry. The application of the model (see *Diagram 13* below) is aimed at meeting the core principle of HKFRS 15 – an entity shall recognize revenue to depict the transfer of promised goods or services to customers, reflecting the amount of consideration to which the entity expects to be entitled in exchange for those goods or services (HKFRS 15 paragraph 2).

Diagram 13 Five-step model



[17] As required by HKFRS 15 paragraph 5, an entity shall apply HKFRS 15 to all contracts with customers except the following:
(a) lease contracts within the scope of HKFRS 16;
(b) insurance contract within the scope of HKFRS 4 *Insurance Contracts*;
(c) financial instruments and other contractual rights or obligations within the scope of HKFRS 9, HKFRS 10 *Consolidated Financial Statements,* HKFRS 11 *Joint Arrangements*, HKAS 27 *Separate Financial Statements* and HKAS 28 *Investments in Associates and Joint Ventures*; and
(d) non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers

It is important to evaluate the contract terms and all relevant facts and circumstances when applying HKFRS 15. An entity shall apply HKFRS 15, including the use of any practical expedients, consistently to contracts with similar characteristics and in similar circumstances (HKFRS 15 paragraph 3).

Members should pay attention that the HKFRS 15 requirements also apply to the recognition and measurement of gains and losses on the transfer of certain non-financial assets that are not an output of the entity's ordinary activities (e.g. sales or transfers of property, plant and equipment and intangible assets) even though such gains or losses do not meet the definition of revenue[18]. Entities should apply the guidance under HKFRS 15 related to the transfer of control and measurement of transaction price, including the constraint on variable consideration, to determine the timing and amount of the gain or loss to be recognized[19].

The following discussions highlight some common or significant issues identified in applying the five-step model under HKFRS 15:

(a) Accounting for bundled sales contracts

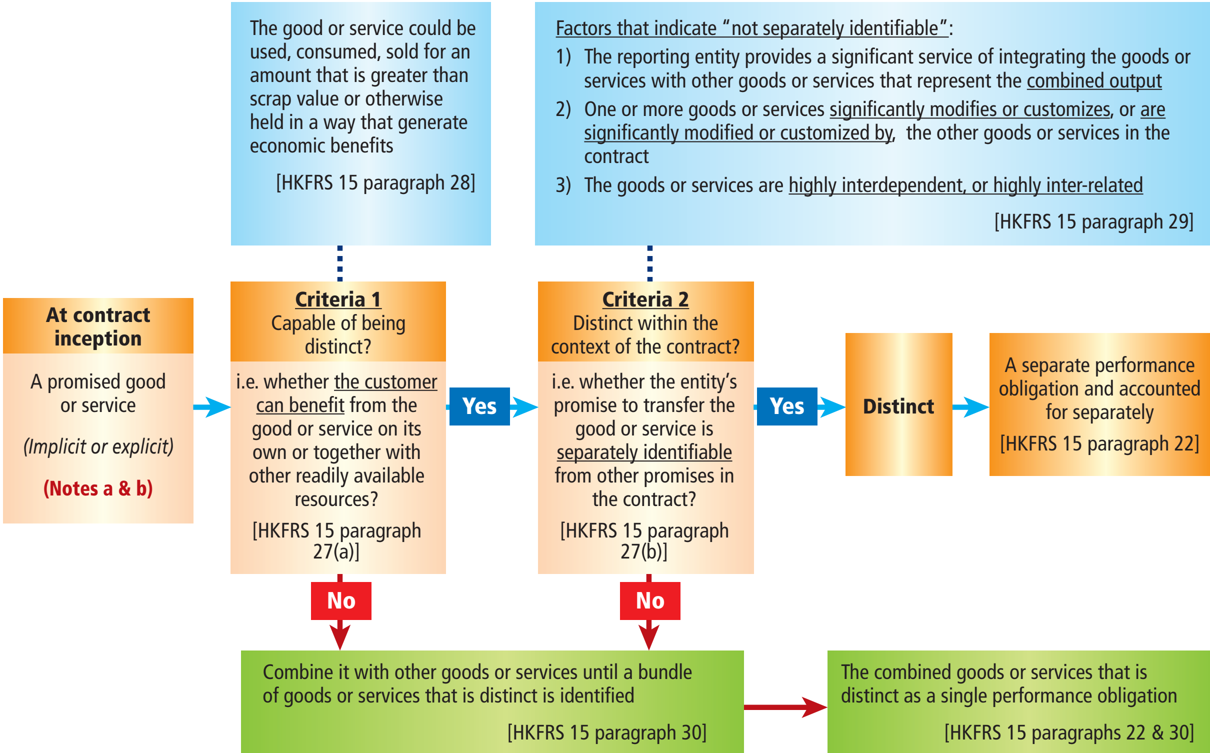
After identifying a contract with a customer, the next step is to assess the contract with a customer which goods or services, or a bundle of promised goods or services are distinct and therefore should be accounted for as separate performance obligations. Such assessment needs to be performed at contract inception (HKFRS 15 paragraph 22). If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. Accordingly, it is possible for some entities to end up with accounting for all the goods or services promised in a contract as a single performance obligation (HKFRS 15 paragraph 30).

As stated, the key determinant for identifying a separate performance obligation is whether a good or service, or a bundle of goods or services is distinct. The following diagram sets out the two criteria that need to be satisfied in determining whether a good or service is distinct.

[18] "Revenue" is defined as "Income arising in the course of an entity's ordinary activities" (HKFRS 15 Appendix A).

[19] Please refer to HKFRS 15 BC57, BC494 to BC503 and the relevant requirements in HKAS 16 *Property, Plant and Equipment* paragraph 69, HKAS 38 *Intangible Assets* paragraph 114, HKAS 40 *Investment Property* paragraph 67 for further information and guidance.

Diagram 14 Identification of obilgation



Note:

a. A promised good or service is generally explicitly stated in a contract with a customer. However, a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer (HKFRS 15 paragraph 24).

b. Performance obligations only include those activities that transfer a good or service to a customer. Activities, such as administrative tasks to set up a contract, which do not transfer a good or a service to the customer, are not a performance obligation (HKFRS 15 paragraph 25).

Our reviews covered the financial statements of various industries. In some cases, based on information provided in the financial statements (e.g. description of the principal activities and source of revenue in MD&A and segment disclosures), it appears that the reporting entities had more than one performance obligations in their contracts with customers. However, in view of the lack of information about the performance obligations (e.g. information about when the entity typically satisfies its performance obligations and the nature of promised goods or services as required by HKFRS 15 paragraph 119 and the accounting policy for identifying performance obligations and bundled sale contracts), it was unclear whether the contracts entered into were bundled contracts; what performance obligations were identified; and whether the identification was appropriate based on the HKFRS 15 requirements.

Some examples are cited below:

- *Construction industry:* The MD&A disclosed that the group's revenue decrease for the year was due to the decrease in the quantity of couplers sold during the year. The financial statements however disclosed that the reporting entity's revenue was solely derived from the provision of mechanical splicing services.

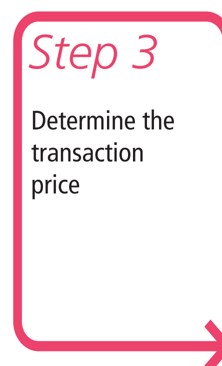
- *Resource industry:* The MD&A section disclosed that the reporting entity engaged in a coal production business and a heating supply business. The segment disclosures further disclosed that the reporting entity's coal production services consisted of coal mining construction engineering, mechanical equipment installation and coal production and technical services.

- *Technology industry:* The MD&A section disclosed that the reporting entity provided services to its customers, which included (1) sourcing of electronic fund transfer point-of-sale terminals and peripheral devices and (2) the development of software and installation and ongoing maintenance and repair services of the electronic point-of-sale terminals.

The above examples indicated that there could be multiple promised goods and/or services in the contracts with customers in the main businesses of the reporting entities. However, it was unclear whether or not the promised goods and/or services in the transactions were separately identifiable (which is a criterion for a performance obligation to be distinct) after consideration of the requirements and the factors set out in HKFRS 15 paragraph 29. If they were assessed as "not separately identifiable" (e.g. due to provision of significant integration services; and the highly inter-dependence nature of the goods or services promised in the contracts), another question arose as to whether the reporting entities had appropriately combined the goods and services with other promised goods and/or services until a bundle of goods and/or services that was distinct was identified. For all these cases, we raised enquiries with the auditor to understand how the reporting entities assessed and identified the distinct performance obligations in their contracts with customers and whether they properly accounted for them according to HKFRS 15.

The identification of performance obligations will have consequences in Step 4 *Allocating the transaction price to the performance obligations in the contract* and Step 5 *Recognize revenue when (or as) the entity satisfies a performance obligation* of the revenue model under HKFRS 15. Therefore, our enquiries with the auditors also included a question about how they were satisfied that the transaction price was properly allocated to the respective distinct performance obligations.

(b) Consideration of the existence of a significant financing component in the contract



The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (e.g. some sale taxes) (HKFRS 15 paragraph 47 and Appendix A). In determining the transaction price, an entity shall consider the effects of variable consideration and the constraining estimates of variable consideration, existence of a significant financing component in the contract, non-cash consideration and consideration payable to a customer (HKFRS 15 paragraph 48). This part explores the issues identified relating to significant financing components.

Conceptually, a contract that has a financing component is comprised of two transactions – one for the sale of goods and/or services and one for financing (HKFRS 15 BC229). The amount of promised consideration for the effects of financing is adjusted for the effect of financing only if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing (HKFRS 15 paragraph 60 and BC229 to BC233). The table below explains the objective, the requirements and different accounting implications for a significant financing component as a result of financing provided to customer and financing provided by customer:

Diagram 15 Significant financing component

Objective	How to assess whether the contract contains a financing component and whether the financing component is significant	Accounting impact	
To recognize revenue at an amount that reflects the **cash selling price** of the underlying goods or services at the time of transfer. **Cash selling price** refers to the price that a customer would have paid for the promised goods or services if the customer had paid cash for those goods or services when (or as) they transfer to the customer. [HKFRS 15 paragraph 61]	• Can be **explicitly** stated in the contract or implied by the payment terms agreed to by the contracting parties **(i.e. implicitly)**. • Perform assessment at individual contract level **(Note a)**. • Consider all relevant facts and circumstances including the combined effect of factors **(Note b)** such as: ✓ The expected length of time between when the entity transfer the goods or services to the customer and when the customer pays for them; ✓ Whether the amount of consideration would substantially differ if the customer paid cash when the goods or services were transferred and ✓ The prevailing interest rates in the relevant market. [HKFRS 15 paragraph 61]	When an entity concludes that a financing component is significant to a contract, • determine the transaction price by discounting the amount of promised consideration; • use the same discount rate that would be used if the entity were to enter into a separate financing transaction with the customer at contract inception. **Discount rate:** • reflects the credit characteristics of the borrower in the contract as well as any collateral or security provided by the customer or the entity; and • shall not be updated for changes in circumstances after contract inception. [HKFRS 15 paragraph 64]	**A. Financing provided to customer** (e.g. customer pays in arrears after receiving promised goods or services, i.e. deferred consideration) ✓ interest income and a reduction in revenue ✓ a receivable in the statement of financial position **B. Financing provided by customer** (e.g. customer pays in advance before receiving the goods or services) ✓ interest expense and increase in revenue ✓ a receipt in advance, i.e. contract liability in the statement of financial position

a. An entity should consider only the significance of a financing component at a contract level rather than consider whether the financing is material at a portfolio level. The boards decided that it would have been unduly burdensome to require an entity to account for a financing component if the effects of the financing component were not material to the individual contract, but the combined effects for a portfolio of similar contracts were material to the entity as a whole (HKFRS 15 BC234).
b. The IASB acknowledged that a difference in the timing between the transfer of and payment for goods or services is not determinative, but the combined effect of the timing and the prevailing interest rates may provide a strong indication that an entity is providing or receiving a significant benefit of financing (HKFRS 15 BC232(b)).

The introduction of the HKFRS 15 requirements on significant financing components may bring changes in practice for some entities as compared to the time when they applied HKAS 18 *Revenue*. There was no requirement under HKAS 18 to require an entity to adjust consideration for a financing component when payments were received in advance from customers. Therefore, before HKFRS 15 was effective, entities ordinarily had not considered whether the payments in advance from customers would have given rise to a financing arrangement.

We encountered a few instances in our reviews in which the reporting entities' financial statements recorded significant deposits received in advance from customers. In those cases, having considered the nature of the deposits and the entities' principal activities, we had doubts whether the reporting entities had adequately identified and assessed whether there was a significant financing component in their contracts with customers and the related accounting implication based on the relevant specific requirements under HKFRS 15.

For example, a reporting entity, which was a property developer, recorded in its financial statements material deposits received from customers in connection with construction contracts and sales of properties. The accounting policy for revenue recognition provided no information about how management would identify and assess (1) whether there were financing components in contracts with customers (no matter explicit or implicit) and (2) if so, whether the financing components were significant. The disclosure note of the composition of finance costs also did not show that the group's finance costs had included any amount which was incurred due to financing provided by customers[20]. Based on these observations and considering that it was prevalent for a property developer to receive proceeds from customers before completion of construction, we were concerned whether the reporting entity had adequately reviewed the contract terms and arrangements with their customers and applied the HKFRS 15 requirements to appropriately account for the significant financing component.

Contractors or property developers may have a practice to require their customers to pay in advance so that they had the necessary funds to cover the costs of construction (e.g. purchases of construction materials and payments of labour costs when the project progresses) in carrying out the long-term construction projects. We would expect these entities to carefully review the contract terms and arrangements in order to critically and properly identify and account for the significant financing components.

[20] An entity shall present the effects of financing (interest revenue or interest expense) separately from revenue from contracts with customers in the statement of comprehensive income (HKFRS 15 paragraph 65).

In general, there should be some reasons why there is a substantial timing difference between the payments of goods or services and their delivery. If this occurs, entities should consider whether there is a significant financing component in the contract, or whether it is due to a reason other than a significant financing component (e.g. the customers paid for the goods or services in advance and the timing of the transfer of goods and services is at the discretion of the customers[21]). An evaluation based on the overall facts and circumstances of the arrangement is needed. Judgement shall be applied in the evaluation process.

HKFRS 15 BC238 specifically discusses why the IASB did not provide an exemption for advance payments from accounting for the effects of a significant financing component. In order to conclude whether an advance payment represents or does not represent a significant financing component, an entity should assess whether or not the advance payment provides a significant benefit and describe its substantive business purpose[22]. To better understand these concepts, members may refer to the two examples provided in Example 29 (IE148 to IE151) and Example 30 (IE152 to IE154) of HKFRS 15 which illustrate an entity's determination that a customer's advance payment represents a significant financing component and an entity's determination that a customer's advance payment does not represent a significant financing component, respectively.

In particular for entities of which receipts of consideration do not match the timing of transfer of goods and services to customers in their ordinary course of business, we recommend them, in disclosing the accounting policy for revenue recognition, provide clear and adequate information of management's consideration of the key factors when identifying and evaluating the existence of a significant financing component; and, where appropriate, the related accounting treatment. The significant judgement applied in the application of the accounting policy should be disclosed in accordance with HKAS 1.

Applicability of practical expedient from consideration of existence of significant financing component

HKFRS 15 paragraph 63 provides a practical expedient that an entity needs not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between the payment and the transfer of the promised goods or services is one year or less. If an entity uses this practical expedient, it would apply the expedient consistently to similar contracts in similar circumstances (HKFRS 15 BC235).

[21] Notwithstanding the assessment in HKFRS 15 paragraph 61 (i.e. whether a contract would indicate that a significant financing component exists), HKFRS 15 provides three situations that the IASB had determined do not provide the customer or the entity with a significant benefit of financing. Please refer to HKFRS 15 paragraph 62 for details of those three situations.

[22] As discussed in FASB/IASB Joint Transition Resources Group ("TRG") for Revenue Recognition (Agenda paper 30 dated 30 March 2015), the Boards readily acknowledged that there may be valid non-financing reasons for an advance payment. In those cases, an entity should establish why that feature of the arrangement is not providing a significant financing benefit, but is instead there for a different and substantive business purpose.

We encountered two cases that the disclosure note of "contract liabilities" mentioned that the reporting entities' performance obligations were expected to be satisfied within one year from the inception of contracts. One of them further mentioned that "the amounts were after the adjustments from the application of HKFRS 15". There were no further disclosures to specifically explain the nature and amounts of the adjustments, e.g. whether the adjustments were made to reclassify the receipts in advance from other payables to contract liabilities, and/or to account for the significant financing component (i.e. financing by customers) as a result of applying HKFRS 15 (if so, the practical expedient under HKFRS 15 paragraph 63 had not been applied even though the performance obligations were to be satisfied within one year or less).

If the reporting entity had elected to use the practical expedient in HKFRS 15 paragraph 63, the fact of applying the practical expedient should have been disclosed as required by HKFRS 15 paragraph 129.

Members should not mix up the application of the practical expedient under HKFRS 15 paragraph 63 with other HKFRS 15 requirements concerning significant financing components. That means that, if the period between the entity transfers a promised good or service to a customer and the customer pays for that good or service is more than one year and the financing component is assessed to be significant, the entity must account for the entire financing component. An entity cannot exclude the first 12 months of the period between the payment from a customer and the transfer of the promised goods and/or services to the customer (1) in determining of whether the financing component is significant; and (2) from the calculation of the adjustment to the transaction price due to the financing component.

Other complexities and implementation questions

There are other complexities and implementation issues in applying the HKFRS 15 requirements on significant financing components. For example, in respect of how to allocate a significant financing component in a contract with a customer that includes multiple performance obligations, the TRG members discussed in its March 2015 meeting and came to a view that it may be reasonable to attribute a significant financing component to one or more, but not all, of the performance obligations in the contract. Entities should consider whether it is appropriate to apply the relevant HKFRS 15 guidance on allocating a discount or allocating variable consideration by analogy and exercise judgement in determining the accounting treatment of a significant financing component in situations with multiple performance obligations[23].

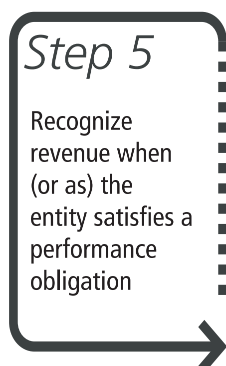
[23] At its meeting in 2015, the TRG members discussed various implementation questions received from stakeholders (e.g. whether IFRS 15 precludes accounting for financing components that are not significant; whether or not the practical expedient can be applied in scenarios in which there is a single payment stream for multiple performance obligations, etc.). To obtain an understanding of the TRG discussions, please see the links below for details:

https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176164720248&d=&pagename=FASB%2FDocument_C%2FDocumentPage [Agenda Paper 20 dated 26 January 2015]

https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176165884373&d=&pagename=FASB%2FDocument_C%2FDocumentPage [Agenda Paper 30 dated 30 March 2015]

(c) Application of "right to invoice" practical expedient under HKFRS 15

After an entity has determined that the performance obligation is satisfied over time, an entity shall recognize revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective is to depict an entity's performance in transferring control of goods or services promised to a customer (i.e. the satisfaction of an entity's performance obligation) (HKFRS 15 paragraph 39).



HKFRS 15 paragraph 41 states that appropriate methods of measuring progress include output methods and input methods[24]. The issue we discussed below was about the use of output method. HKFRS 15 paragraph B15 states that output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.

A reporting entity disclosed in its financial statements that the group had applied the "right-to-invoice" practical expedient under HKFRS 15 to recognize the revenue from provision of property management services over time in the amount to which the group had a right to invoice. However, the disclosure also mentioned that the group was entitled to bill a fixed amount in advance for each month according to the terms of the relevant contract.

HKFRS 15 paragraph B16 states that *"As a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (e.g. a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice"* (underline added).

It is clearly set out in HKFRS 15 paragraph B16 that an entity may recognize revenue on the "right-to-invoice" basis, on the condition that the entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of its performance completed to date. In the above example, in relation to the practical expedient, the reporting entity's disclosure indicated that the group was entitled to bill a "fixed amount" in advance for each month's services. The billing in advance arrangement apparently did not reflect "performance completed to date". The disclosure provided no further information as to explain the timing of recognizing the property management revenue. Therefore, it was unclear whether revenue was recognized at the time when the invoices were issued to customers at the beginning of the month; if so, it would have been inappropriate as the services for that month had not yet been provided. More disclosures would be helpful to enable users to better understand the timing of recognition of this kind of revenue.

[24] As stated in HKFRS 15 BC159, the IASB decided that it would not be feasible to consider all possible method and prescribe them when an entity should use each method. An entity should use judgement when selecting an appropriate method of measuring progress towards complete satisfaction of a performance obligation. This does not mean that an entity has a "free choice". An entity should select a method of measuring progress that is consistent with the clearly stated objective of depicting the entity's performance – i.e. the satisfaction of an entity's performance obligation – in transferring control of goods or services to the customer.

Members should bear in mind that, regardless of which method is used, an entity shall exclude from the measure of progress any goods or services for which control has not been transferred to a customer (HKFRS 15 paragraph 42). Under the practical expedient, entities may recognize revenue for services performed based on invoiced amounts (i.e. measurement of revenue) under certain circumstances but that does not mean that they can also recognize revenue based on the invoice date (i.e. timing of revenue recognition). Revenue should be properly recognized based on the progress of satisfaction of the performance obligation.

Other reminder

HKFRS 15 paragraph 40 requires an entity to apply a single method of measuring progress for each performance obligation satisfied over time and the entity shall apply that method consistently to similar performance obligations and also across contracts that have performance obligations in similar circumstances. An entity should not use different methods to measure its performance in satisfying the same or similar performance obligations, otherwise that entity's revenue would not be comparable in different reporting periods (HKFRS 15 BC161).

(d) Other HKFRS 15 application issues

In our 2020 reviews, we identified recurring application issues concerning the following aspects:

- Pattern of revenue recognition – over time or at a point in time
- Warranty services
- Licence of intellectual properties

As those issues were similar to those that we discussed in our QAD 2019 annual report, we shall not cover them again here this year. Members are encouraged to refer to the relevant sections in our QAD 2019 annual report for information.

3. HKFRS 10 *Consolidated Financial Statements*

HKFRS 10, which was effective in 2013, provides a single consolidation model that identifies control as a basis for consolidation of all types of entities. We discussed the issues identified relating to application of HKFRS 10 in our QAD 2014 and 2017 annual reports. We consider that it is an appropriate time to remind some key requirements of HKFRS 10 by sharing with members an example we identified in our 2020 reviews.

HKFRS 10 paragraph 7 states that an investor controls an investee if and only if the investor has all of the following three criteria:

(a) power over the investee;

(b) exposure, or rights, to variable returns from its involvement with the investee; and

(c) the ability to use its power over the investee to affect the amount of the investor's returns.

Power arises from rights. In the absence of an indication of any other factors, an assessment of power sometimes can be straightforward by simply basing on the voting rights from shareholdings. However, there are also situations where the assessment is more complex and require more consideration, for example, when the power results from one or more contractual arrangements (HKFRS 10 paragraph 11). A thorough review of the contractual arrangements entered into by the investor and investee is therefore important in identifying which investor has power over the investee. Very often, a structured entity's relevant activities are directed by contractual arrangements. In this part, we shall discuss issues found on the assessment of existence of an entity's power and control over another entity which appears to be a structured entity[25].

HKFRS 12 *Disclosure of Interests in Other Entities* Appendix A defines a structured entity as an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. It is worth noting that an entity that is controlled by voting rights is not a structured entity simply because, for example, it receives funding from third parties following a restructuring (HKFRS 12 paragraph B24).

An entity shall apply the same approach as stated in HKFRS 10 paragraph 7 (i.e. power over the relevant activities, exposure to variable returns and the ability to affect those returns through its power over the structured entity) to evaluate whether it, as an investor, has control over the investee.

A set of financial statements reviewed disclosed that the reporting entity established a share incentive scheme to provide an incentive to its key management personnel ("beneficiaries") who had or would make contribution to the group's development. The incentive scheme involved trust arrangements. The reporting entity issued shares to an entity ("Entity A") which held the shares on trust for the beneficiaries under the trust arrangements. We identified the following information about Entity A in the annual report of the reporting entity:

- Entity A was set up for the purpose of holding the shares on trust for the beneficiaries pursuant to the share incentive scheme;
- The chairman of the board of directors and the CEO of the reporting entity, who were also the trustees of those trusts, each owned 50% of the equity interest in Entity A; and
- Entity A borrowed fund from its shareholders for financing its subscription of the reporting entity's shares. The financial statements disclosed that the shareholders borrowed the same amount of fund from the reporting entity shortly before Entity A's subscription of shares of the reporting entity.

[25] IFRS 12 introduces the term "structured entity". The type of entity the IASB envisages being characterized as a structured entity is unlikely to differ significantly from an entity that SIC-12 *Consolidation—Special Purpose Entities* described as a special purpose entity ("SPE"). SIC-12 described an SPE as an entity created to accomplish a narrow and well-defined objective, listing as examples entities established to effect a lease, research and development activities or a securitization of financial assets (HKFRS 12 BC82).

HKFRS 12 paragraphs B22 to B24 explain some features or attributes of a structured entity, e.g. a structured entity often has restricted activities (HKFRS 12 paragraph B22(a)), a narrow and well-defined objective (HKFRS 12 paragraph B22(b)) and/or there is insufficient equity to permit the structured entity to finance its activities without subordinated financial support (HKFRS 12 paragraph B22(c)).

Based on the above fact patterns, it appears that Entity A had the features or attributes of a structured entity, i.e. (1) being set up for the purpose of holding the shares of the reporting entity on trust under the share incentive scheme; (2) the subscription of the reporting entity's shares in substance being financed by the fund borrowed from the reporting entity; and (3) the trustees of those trusts were key management personnel of the reporting entity. In this regard, provided that the share incentive scheme arranged with Entity A is not scoped out from HKFRS 12 (HKFRS 12 paragraph 6), the key issue here is whether Entity A was a structured entity under HKFRS 12, over which the reporting entity had control even without equity interest; and if so, Entity A should have been consolidated into the group's consolidated financial statements under HKFRS 10.

There was also no disclosure of the consideration given and significant judgment applied by management to support that Entity A should not be consolidated into the group's consolidated financial statements despite Entity A having features of a structured entity as envisaged under HKFRS 12. Accordingly, enquiries with the auditor are being made to understand (1) management's rationale and consideration given (e.g. the right and power of the reporting entity to direct the relevant activities of Entity A and operations of the trusts; the possible impact if the chairman and the CEO of the reporting entity no longer worked for the reporting entity) to arrive at the management's conclusion that the reporting entity did not have control over Entity A and therefore it was appropriate not to consolidate Entity A into the reporting entity's consolidated financial statements under HKFRS 10; and (2) how the auditor was satisfied with management's rationale and considered the management's consideration justifiable.

Members should pay attention that there are certain disclosure requirements of HKFRS 12 that only apply to structured entities, both consolidated (HKFRS 12 paragraphs 14 to 17) and unconsolidated (HKFRS 12 paragraphs 24 to 31).

Section III – Common disclosure and presentation deficiencies

We identified a number of disclosure deficiencies in our 2020 reviews. Some of them are new but some are recurring. Disclosure deficiencies relating to application of HKFRS 8 *Operating Segments*, HKFRS 13 *Fair Value Measurement*, HKAS 1 (Revised) *Presentation of Financial Statements*, HKAS 7 *Statement of Cash flows* and HKAS 36 *Impairment of Assets* have been discussed a few times in previous years' reports and therefore we shall not cover them in this year's report. Members may refer to the webpage below which provides a full list of all QAD reports issued in past years:

https://www.hkicpa.org.hk/en/Standards-and-regulation/Quality-assurance/Professional-standards-monitoring/Publications-and-Reference-Materials

We shall highlight below some other disclosure deficiencies identified:

1. HKAS 12 *Income Taxes*

The following disclosures were often missing or incomplete:

- the expiry date of the unused tax losses for which no deferred tax asset is recognized in the statement of financial position (HKAS 12 paragraph 81(e));
- an explanation of changes in the applicable tax rate(s) compared to the previous accounting period (HKAS 12 paragraph 81(d));
- the aggregate amount of temporary differences associated with investments in subsidiaries (e.g. undistributed profits) for which deferred tax liabilities have not been recognized (HKAS 12 paragraph 81(f)); and
- for each type of temporary difference (e.g. provisions, tax losses, accelerated tax depreciation and investments in associates), the amount of the deferred tax income or expense recognized in profit or loss, if this is not apparent from the changes in the amounts recognized in the statement of financial position (HKAS 12 paragraph 81(g)(ii)).

2. HKFRS 7 *Financial Instruments: Disclosures*

The following disclosures were often missing or incomplete:

- a disclosure of the carrying amounts of each category of financial assets and financial liabilities as specified in HKFRS 9 in the statement of financial position or in the notes (HKFRS 7 paragraph 8);
- a maturity analysis for all non-derivative financial liabilities (e.g. promissory note repayable more than one year) that shows the remaining undiscounted contractual cash flows (HKFRS 7 paragraphs 39(a) and B11D);

- information with regard to credit risk and expected credit losses required by HKFRS 7 e.g. :
  - the basis of inputs and assumptions and the estimation techniques used to measure the 12-month and lifetime expected credit losses; and how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macroeconomic information (HKFRS 7 paragraph 35G(a)(i) and (b));
  - how an entity determines whether the credit risk of financial instruments (e.g. interest rate swap receivables, loans to associates/joint ventures and other receivables) has increased significantly since initial recognition, including, if and how, financial instruments are considered to have low credit risk in accordance with HKFRS 9 paragraph 5.5.10, including the classes of financial instruments to which it applies; and the presumption in HKFRS 9 paragraph 5.5.11, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted (HKFRS 7 paragraph 35F(a)(i) and (ii));
  - an entity's definitions of default, including the reasons for selecting those definitions (HKFRS 7 paragraph 35F(b));
  - how the instruments (e.g. trade receivables) were grouped if expected credit losses were measured on a collective basis (e.g. past due status and credit risk ratings) (HKFRS 7 paragraph 35F(c));
  - an explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance (HKFRS 7 paragraph 35I);
  - by class of financial instrument, the amount that best represents the reporting entity's maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements; a narrative description of collateral held as security and other credit enhancements; and quantitative information about the collateral held as security and other credit enhancements for financial assets that are credit-impaired at the reporting date (HKFRS 7 paragraph 35K(a) to (c)); and
  - by credit risk rating grades, the gross carrying amount of financial assets (e.g. trade receivables, finance lease receivables, loan to associates and joint ventures and other financial assets) for which the loss allowance is measured at an amount equal to 12-month and at an amount equal to lifetime expected credit losses (HKFRS 7 paragraph 35M(a) and (b)).

3. HKFRS 12 *Disclosure of Interests in Other Entities*

The following disclosures were often missing or incomplete:

- financial information about an entity's immaterial joint ventures and associates including the aggregate amount of its share of those joint ventures' or associates' (a) profit or loss from continuing operations; (b) post-tax profit or loss from discontinued operations; (c) other comprehensive income and (d) total comprehensive income. (HKFRS 12 paragraph B16(a) to (d)); and
- a summarized financial information of each subsidiary that has non-controlling interests that are is material to the reporting entity (HKFRS 12 paragraph 12(g) and B10).

4. HKFRS 15 *Revenue from Contracts with Customers*

As mentioned in our QAD 2019 report, we encountered cases where the disclosed accounting policy for revenue recognition was somewhat boilerplate or generic. We continued to find such deficiencies in our 2020 reviews, where the reporting entities did not disclose sufficient information about how the entities accounted for revenue based on their circumstances (e.g. how the entities, which had bundled contracts, identified and accounted for performance obligations as discussed in Section II 2(a) Accounting for bundled sales contracts above). This raised doubts whether the disclosure objective set out in HKFRS 15 paragraph 110 – *"to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers"* – has been achieved.

Apart from the above, the following disclosures were often missing or incomplete:

- the amount of revenue recognized from contracts with customers, which the entity shall disclose separately from its other sources of revenue (HKFRS 15 paragraph 113(a));
- disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors (HKFRS 15 paragraphs 114, B88 and B89);
- the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed (HKFRS 15 paragraph 116(a));
- revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period; and revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (HKFRS 15 paragraph 116(b) and (c));
- an explanation on how the timing of satisfaction of the entity's performance obligations relates to the typical timing of payment and the effect that those factors have on the contract asset and the contract liability balances (HKFRS 15 paragraph 117);

- information about an entity's remaining performance obligations of (a) the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period; and (b) an explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with HKFRS 15 paragraph 120(a) (HKFRS 15 paragraphs 120 to 122);
- for performance obligations that an entity:
  - satisfies over time, the methods used to recognize revenue and an explanation of why the methods used provide a faithful depiction of the transfer of goods or services (HKFRS 15 paragraph 124);
  - satisfies at a point in time, the significant judgements made in evaluating when a customer obtains control of promised goods or services (HKFRS 15 paragraph 125); and
- for disclosure of disaggregated revenue information, the amount of revenue recognized at a point in time and amount recognized over time (HKFRS 15 paragraph B89(f)).

Risk-based Supervisory Programme of AML / CTF Compliance

Background

The amended AMLO, effective on 1 March 2018, extended the scope of legislation to cover designated non-financial businesses and professions, including accounting professionals, and designated the Institute as the regulatory body of accounting professionals (defined in the AMLO as certified public accountants ("CPAs") as well as practice units). In October 2018, the Institute launched its ACMR programme within the Institute's practice review function to monitor the level of compliance by practices with the AML Guidelines which have been effective since 1 March 2018.

In November 2018, the FATF conducted a mutual evaluation on Hong Kong to assess Hong Kong's level of compliance with the FATF recommendations and the effectiveness of its AML / CTF system. In September 2019, the FATF issued its mutual evaluation report on Hong Kong. In its report, FATF recommended the Institute to continue to develop its assessment of sectoral ML / TF risks and to strengthen its understanding of ML / TF risks at the institutional level to develop a more robust risk-based supervision plan. The FATF also recommended the Institute should conduct appropriate monitoring and follow up to ensure compliance by accounting professionals with AML / CTF requirements.

__FATF__ is an independent inter-governmental body that develops and promotes policies to protect the global financial system against ML, TF and the financing of proliferation of weapons of mass destruction. The FATF Recommendations are recognised as the global AML / CTF standard.

In response to the recommendations made by the FATF, the Institute has plans to enhance the risk-based supervisory programme. On 1 June 2020, the Institute issued Financial Reporting, Auditing and Ethics Alert 34 ("Alert 34") to inform all CPAs and practice units the key actions that the Institute planned to take to enhance risk-based supervision.

Alert 34

Chapter G of Code of Ethics

As part of the plan to enhance risk-based supervision of AML / CTF compliance, the Institute issued the exposure draft of Chapter G of the Code of Ethics *Professional Ethics Relevant to AML / CTF Compliance for Accounting Professionals* ("Exposure Draft") on 20 July 2020 and invited members to provide comments on the Exposure Draft. The Exposure Draft, a short 8-page document, mainly proposed to establish two obligations on members and practice units:

1. obligation to provide AML / CTF related information to the Institute for AML / CTF regulatory purposes; and

2. obligation on those acting as those charged with governance to ensure their relevant HKNPSEs comply with applicable AML / CTF laws and regulations as if they were a practice unit.

HK Network and Professional Service Entities ("HKNPSEs") *include: (a) network firms located in Hong Kong; and (b) professional service entities whose owners, shareholders or partners are all CPAs and / or practice units.*

The consultation period of the Exposure Draft ended on 20 October 2020, and the Institute received 19 written comments from 17 members and accounting organizations. Concerns raised by the contributors were mainly related to the conduct of the consultation, legitimacy and legal backing of the proposals in the Exposure Draft, expanding the supervision scope to members that do not provide audit and assurance services and HKNPSEs, and consequences of not complying with the obligation to provide information.

It is understandable that members might have concerns about new regulations. However, in order to fulfil its regulatory responsibilities, the Institute will have to meet the expectation required of it being a responsible AML / CTF regulator of the accounting professionals. The Institute obtained a Counsel opinion which confirms that the promulgation of Chapter G is within the legal power of the Institute. In particular, the proposals in the Exposure Draft will allow the Institute to build on the current legislative framework to make the AML / CTF regulatory regime align closer with the FATF recommendations before legislation changes will be able to be effected. The Institute will keep members and practice units informed of further developments relating to Chapter G.

Questionnaire on AML / CTF Compliance

Risk assessment is the starting point to enhance risk-based supervision. To enable the Institute to collect sufficient relevant information to assess the ML / TF risks of accounting professionals at the sectoral level and the institutional level, the Institute released a non-mandatory Questionnaire on AML / CTF Compliance of Accounting Professional ("AML Questionnaire") to all members and practice units (approximately 48,000) on 6 November 2020.

Key information obtained from members and practice units included:

1. Whether they provided professional services by way of business during the period covered by the AML Questionnaire;

2. Their business information including the number of staff, number of clients, types of professional services provided, whether services involved Specified Transactions and whether they applied "good practices" in transactions other than Specified Transactions;

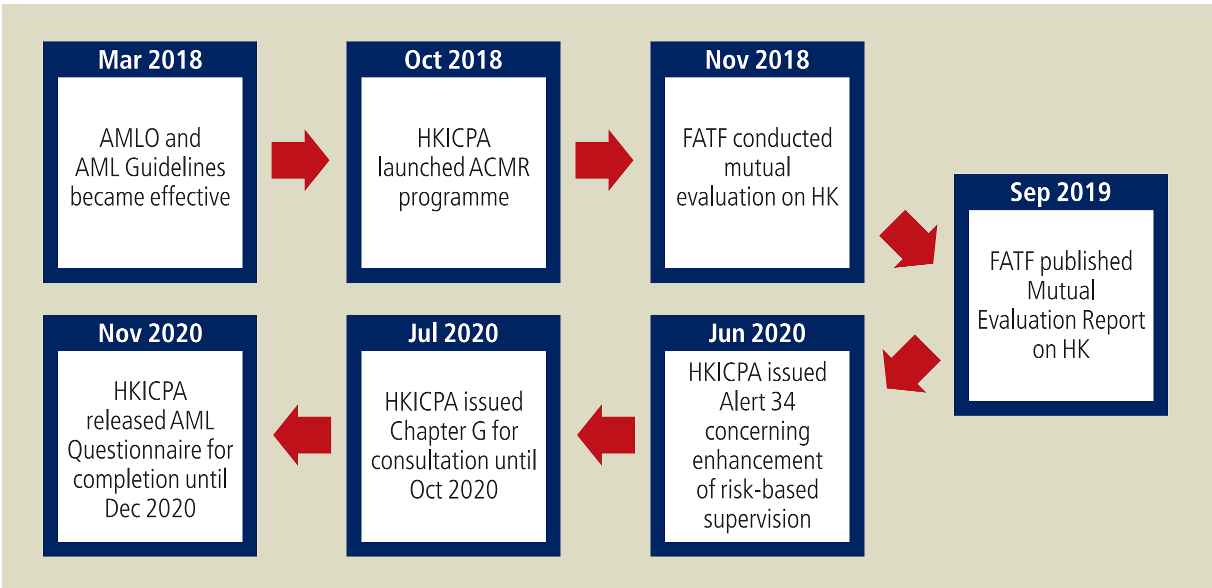
3. Their ML / TF risks (in terms of client, service, geography and delivery channel) exposures and policies, procedures and controls in their AML / CTF compliance programme;

4. Their measures in relation to suspicious transactions reporting, financial sanctions and terrorist financing and AML / CTF training; and

5. The number, names and relevant regulators of their HKNPSEs.

The extent of the above information that was requested to be provided by each member and practice unit varied, depending on whether (1) it provided professional services by way of business to clients; (2) the professional services provided involved Specified Transactions; and (3) it applied "good practices" according to section 600.2 of the AML Guidelines.

The AML Questionnaire was closed on 28 December 2020 and approximately 3,800 members and practice units responded to the AML Questionnaire. The information collected from members and practice units will be used by the Institute to determine the next course of actions regarding the risk-based supervisory programme.



Key events relating to risk-based supervisory programme of AML / CTF compliance

Way forward

In response to the comments made by the FATF in its mutual evaluation report, Hong Kong is required to submit a follow up report in 2022. The Institute will need to implement measures to enhance risk-based supervision as early as possible in order to have sufficient time to enable it to provide information and data to demonstrate effective implementation in the follow up report.

In 2021, taking into account the consultation comments received and information obtained from the AML Questionnaire, we will work out a plan to take the proposals on enhancement of AML / CTF risk-based supervision forward. In doing so, we will engage in dialogues with stakeholders including various committees of the Institute, the government and professional organizations to exchange views concerning the development of the risk-based supervisory programme. We will also take part in various educational activities to deliver latest updates relating to AML / CTF compliance to members and practice units.

We have prepared a designated page which summarizes useful information and updates relating to AML / CTF risk-based supervision. The page can be found at: https://www.hkicpa.org.hk/en/Standards-and-regulation/Quality-assurance/Risk-based-Supervisory-Programme-of-AML-Compliance. We would encourage members and practice units to keep a close watch on the designated page to learn about the latest development of the AML / CTF risk-based supervision.

Designated page on Risk-based Supervisory Programme of AML / CTF Compliance

Communication with members

The results of both programmes are communicated to members to improve their understanding and application of professional standards and raise the quality of auditing and financial reporting. More common and significant matters found in the review programmes were communicated to members through different channels:

- The QAD launched an e-seminar on "Quality Assurance Reviews" in September 2020. This e-seminar is open for subscription for a year and covers key issues identified from the 2019 Practice Review Programme (which includes the audit and assurance quality reviews and ACMRs) as well as the Professional Standards Monitoring Programme. Selected contents of the e-seminar were presented by the QAD team in a webinar organized by the Society of Chinese Accountants and Auditors in January 2021.

- The QAD team participated in the practice review session of the 2020 SMP Symposium (Webinar) in November 2020 which attracted approximately 350 attendees.

- The QAD team participated in the practice review session of an Industry Update Relating to Licensed Corporations in December 2020 which attracted approximately 160 attendees.

- The QAD issued a number of publications including an annual report and alerts covering topics such as (1) risk-based supervision of accounting professionals concerning AML / CTF compliance; and (2) compliance work for regulated entities.

- The QAD developed a number of frequently asked questions concerning practice reviews and AML / CTF compliance that are available on the Institute's website. An article relating to risk-based supervision of accounting professionals concerning AML / CTF compliance was published in June 2020 issue of A Plus.

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

Members of the Regulatory Oversight Board in 2020

Name	Position	Company
Ms. HO, Shuk Yee, Susie	Chairman	
Dr. AU, King Lun (Appointed 24 January 2020)	Member	Government of HKSAR
Mr. CHAN, Kam Wing, Clement	Member	BDO Limited
Miss CHAN, Mei Bo, Mabel	Member	Grant Thornton (Hong Kong) Limited
Ms. CHUNG, Lai Ling (Resigned 16 September 2020)	Member	Government of HKSAR
Mr. HO, Chiu Ping, Dennis	Member	PricewaterhouseCoopers
Ms. HUI, Grace (Appointed 24 January 2020)	Member	Hong Kong Exchanges and Clearing Limited
Mr. POGSON, Timothy Keith	Member	Ernst & Young
Mr. SUN, Tak Kei, David (Appointed 24 January 2020)	Member	Retired
Mr. YIH, Lai Tak, Dieter, JP	Member	Kwok Yih & Chan

Members of the Practice Review Committee in 2020

Name	Position	Company
Mr. HEBDITCH, Paul Donald	Chairman	Ernst & Young
Mr. LIU, Eugene	Deputy Chairman	RSM Hong Kong / RSM Nelson Wheeler
Mr. BROADLEY, Derek Thomas	Member	Deloitte Touche Tohmatsu
Mr. CHAN, Tze Kit	Member	Grant Thornton Hong Kong Limited
Mr. CHIU, Wing Cheung, Ringo (Appointed 24 January 2020)	Member	BDO Limited
Mr. CHUI Cheuk Yin, Bruce	Member	Bruce C.Y. Chui & Co.
Mr. KWOK, Kin Leung	Member	HLB Hodgson Impey Cheng Limited
Mr. LAU, Ho Kit, Ivan (Appointed 24 January 2020)	Member	H.K. Lau & Co.
Mr. LO, Charbon	Member	Crowe (HK) CPA Limited
Mr. NG, Kam Wah, Webster	Member	Webster Ng & Co.
Ms. NG, Shun Yin	Member	KPMG
Mr. PANG, Wai Hang	Member	SHINEWING (HK) CPA Limited
Ms. TSUI, Maria Yuk Hung	Member	PricewaterhouseCoopers
Mr. WONG, Chun Bong	Member	C.B. Wong & Co / BONWAY CONSULTANCY LIMITED

Members of the Task Force on Risk-based Supervision of Accounting Professionals concerning AML / CTF Compliance in 2020

Name	Position	Company
Miss GOVINDARAJU, Shanti (Appointed 22 June 2020)	Chairman	PricewaterhouseCoopers
Mr. CHAN, Stephen Siu Lun (Appointed 22 June 2020)	Member	BDO Limited
Mr. CHEUNG, Fung Yu Chris (Appointed 22 June 2020)	Member	Deloitte China
Mr. LUNG, Wai Lap Samuel (Appointed 22 June 2020)	Member	Ernst & Young Advisory Services Limited
Mr. NG, Kam Wah, Webster (Appointed 22 June 2020)	Member	Webster Ng & Co.
Mr. STEVENSON, James Gary (Appointed 22 June 2020)	Member	RSM Hong Kong
Mr. WONG, Chun Sek, Edmund (Appointed 22 June 2020)	Member	Patrick Wong C.P.A. Limited
Ms. WONG, Jacqueline (Appointed 22 June 2020)	Member	KPMG
Mr. YEUNG, Chi Wai, Edwin (Appointed 22 June 2020)	Member	Edwin Yeung & Company (CPA) Limited

Members of the Professional Standards Monitoring Expert Panel in 2020

Name	Position	Company
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Miss HSIANG, Yuet Ming	Member	BDO Limited
Mr. KWONG, Kam Wing, Kelvin	Member	Grant Thornton Hong Kong Limited
Mr. LAI, Tak Shing, Jonathan	Member	HLB Hodgson Impey Cheng Limited
Mr. LEE, Chi Man	Member	Deloitte Touche Tohmatsu
Mr. ONG, Wei Dong	Member	Hong Kong Exchanges and Clearing Limited
Ms. SO, Hung, Shelley	Member	PricewaterhouseCoopers
Mr. STEVENSON, James Gary	Member	RSM Hong Kong
Miss TANG, Kwan Lai (Appointed 24 January 2020)	Member	SHINEWING (HK) CPA Limited
Mr. TANG, Yiu Chung (Appointed 24 January 2020)	Member	KPMG

Independent Reviewers of the Professional Standards Monitoring Programme in 2020

Company

BDO Limited

Deloitte Touche Tohmatsu

Ernst & Young

Grant Thornton Hong Kong Limited

HLB Hodgson Impey Cheng Limited

KPMG

PricewaterhouseCoopers

RSM Hong Kong

SHINEWING (HK) CPA Limited

ZHONGHUI ANDA CPA Limited

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

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