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

Professional Standards Monitoring Committee
Operations Report 2007

Content

Introduction

1. The Professional Standards Monitoring Committee ("Committee") has been operating since 1988. Over the years, the Committee has played an important role in the self-regulatory function of the Hong Kong Institute of Certified Public Accountants ("Institute").

2. The Committee conducts a continuous review of published financial statements. The main objective of the review is to monitor the compliance with professional standards of members engaged in the preparation or audit of financial statements of listed entities. High standards of financial reporting in Hong Kong can enhance the credibility of financial statements and confidence in Hong Kong's capital markets.

3. The Committee primarily monitors compliance with accounting and auditing standards. Through enquiries to auditors and/or preparers of financial statements, the Committee identifies and considers instances of non-compliance with professional standards, and suggests means by which the Institute may provide assistance to its members. In carrying out those activities, the Committee hopes to enhance the quality of financial reporting in Hong Kong.

4. Where there is a reasonable suspicion and belief that a member is in breach of professional standards, or, in exceptional cases, if there is a prima facie case that the subject member has breached professional standards, the Committee will refer the case to Council for its consideration to take appropriate investigative or disciplinary actions.

5. With effect from 16 July 2007, the Financial Reporting Council ("FRC"), an independent statutory body set up to investigate auditing irregularities and reporting non-compliance in

relation to listed entities, was fully operational. The enabling legislation of the FRC means that the FRC will now be responsible for investigating "relevant irregularities and non-compliance". Accordingly, when the Committee has reasonable suspicion or belief of non-compliance with professional standards by its members in the preparation or auditing of a listed entity's financial statements, it refers the case to Council for making complaints to the FRC in accordance with agreed protocols. The Institute, like other bodies with regulatory responsibility, finalised its working arrangements with the FRC through a Memorandum of Understanding in February 2008 to ensure efficient and effective co-operation and co-ordination of their respective functions.

6. The purpose of this Report is to set out the processes undertaken in relation to the Committee's review of financial statements, the Committee's work completed in 2007 and the composition of the Committee.

7. Important findings and educational points noted by the Committee during its review of the financial statements of listed entities carried out in 2007 are shown in the Appendix. Members of the Institute (whether as auditors or preparers of financial statements) are advised to read through them, as they are beneficial for improving the quality of financial reporting.

8. The Committee believes that including the topics mentioned above in this report, in addition to being useful to members, will also enhance the mutual understanding and the transparency of the Committee's work.

Process

9. The Committee selects for its review published financial statements of the entities listed on the Hong Kong Stock Exchange (both Main Board and Growth Enterprise Market issuers) based on certain selection criteria (see paragraph 11 below). At the start of the review process, each set of selected financial statements is distributed to two monitors, who are representatives nominated by the practising firms with more than 20 listed entity clients, for first review. After receiving the reports from the monitors, the Committee considers the review comments from the monitors and the Secretariat's recommendation on those comments and resolves how to proceed with the case after deliberation during a Committee meeting.

10. Enquiry letters are issued to the members of the Institute, in most cases the auditors, if there are matters in respect of the financial statements under the Committee's review that require them to explain or to provide information. The Committee decides on an appropriate action based on the replies from the members concerned.

Selection criteria

11. In selecting the published financial statements for review in 2007, the Committee continued to adopt a "risk-based" approach and applied the selection criteria set out in paragraph 12 below. The Committee considered that the risk to the public is high if auditors issued an unqualified audit opinion on financial statements which should have been qualified. In order to capture financial statements with potentially inappropriate audit opinions, more financial statements with unqualified opinions have been selected on a random basis. Financial statements of newly listed companies were no longer identified as a separate selection category but were included in the random basis category. Financial statements with changing auditors and indication of potential accounting / auditing issues were considered during the selection.

12. In 2007, financial statements were selected for review in the following proportions:
    - Financial statements on which qualified / modified audit opinions were given (31%)
    - Financial statements with alleged financial / accounting irregularities (4%)
    - A random sample of financial statements of other listed companies (65%)

13. The Committee considered that this allocation of financial statements reviewed gave adequate focus on financial statements with a higher risk of non-compliance with professional standards.

Work completed in 2007

14. In 2007, the Committee gave priority to the completion of old cases brought forward from previous years. During the year, the Committee held 11 meetings at which 68 sets of financial statements (approximately 6 percent of total listed entities in Hong Kong) were reviewed, and handled 68 replies brought forward from 2006 and followed up on 48 replies arising from the 68 new cases discussed in 2007.

15. The review of published financial statements in 2007 was performed with reference to the applicable financial reporting and auditing standards in force at the relevant time.

16. The Committee issued more than 100 letters to auditors for enquiries or comments, which arose from its review of financial statements. This process is interactive and is not a unilateral check of the quality of financial reporting.

17. Of all the cases reviewed during the year, 97 were closed and 47 were carried forward to 2008. The Committee also referred two cases to Council and recommended that Investigation and Disciplinary Committees be constituted, as appropriate.

Committee in 2007

18. To obtain unbiased and balanced views, the Committee included members with in-depth knowledge of accounting and auditing standards and extensive experience in auditing or preparing financial statements of listed companies.

19. The Committee includes members with the following background:

Practising members:	
Big-Four firms	5
Small and medium sized practitioners	7
Non-practising members:	
Listed entities	1
Regulator	1
	14

Summary

20. The Committee appreciates the contributions of the monitors in assisting the Institute in reviewing the listed entities' financial statements.

21. The Committee is grateful for the co-operation of all Institute members subject to enquiry during the course of its review activity and is encouraged by the understanding of members that public interest requires preparers and auditors of listed entities' financial statements to place great emphasis on quality of financial reporting.

22. While this report reflects the view of the Committee, members are welcome to write to the Institute to provide their comments on the professional standards monitoring process.

[February 2008]

Members of the Professional Standards Monitoring Committee in 2007

Thomas Wong (Chairman)

Raphael Ding (Deputy Chairman)
(since February 2007)

Keith Pogson (Deputy Chairman)

Raymond Cheng

Olivia Cheung

Charles Chow

Jack Chow

Peter Chow *(since February 2007)*

Tommy Fung *(since February 2007)*

Paul Hebditch

Jonathan Leong

Paul Ng

Stephen Taylor

Eddy Yan

This Operations Report is also available at the Institute's website http://www.hkicpa.org.hk/professionalcompliance/standards/rm_doc/2007_PSMC.pdf.

Appendix: Findings and Educational points

The Committee reviewed published financial statements with reference to the applicable financial reporting and auditing standards in force at the relevant time. Apart from issuing enquiry letters to the auditors concerned, the Committee considers that the findings and educational points are useful to members who are preparing or auditing financial statements. It is worth highlighting that members have the primary obligation to keep themselves abreast of the latest developments in financial reporting and auditing standards.

1. *Business combinations and goodwill*

The Committee noted an overall improvement in the standard of financial reporting in relation to business combinations in the cases the Committee reviewed. In minority of cases, the following deficiencies were identified where further actions should be taken by members to familiarise themselves with the requirements of the Standard:

- failure to recognise separately intangible assets such as customer relationship, brandname, in-process research and development projects and contingent liabilities upon acquisition of subsidiaries; (paragraphs 37, 45 and 47 of HKFRS 3 Business Combinations);
- failure to recognise deferred tax assets/ liabilities in connection with fair value adjustments resulting from business combinations and adjust goodwill accordingly after the initial accounting is complete (paragraph 65);
- failure to disclose information on business combinations effected after the balance sheet date but before the financial statements are authorised for issue (paragraph 66(b));
- failure to disclose factors that result in the recognition of goodwill, description of each intangible asset not recognised separately from goodwill, an explanation of why intangible asset's fair value could not be measured reliably or nature of any excess recognised in profit or loss in accordance with paragraph 56 (paragraph 67(h));
- failure to disclose information on each business combination that is individually material (paragraph 68); and
- failure to disclose revenue and profit or loss of the combined entity for the period as though the acquisition date for all business combinations effected during the period had been the beginning of that period (paragraph 70).

The Committee advises members be mindful of the definition of business when determining whether an acquisition of an entity should be accounted for as a business combination under HKFRS 3. Acquisition of an asset or a group of assets that does not constitute a business is not a business combination and does not give rise to goodwill. HKFRS 3 defines business as an integrated set of activities and assets conducted and managed for the purpose of providing a return to investors or lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of inputs, process applied to those inputs and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business (Appendix A to HKFRS 3).

2. *Presentation of financial statements*

The review of financial statements by the Committee indicated that more emphasis needed to be placed in the following areas:

- missing or inadequate disclosure relating to nature and purpose of each reserve within equity (e.g. capital reserve and contributed surplus reserve) (paragraph 76(b) of HKAS 1 Presentation of Financial Statements);
- failure to disclose the total of income and expenses recognised directly in equity and the total of income and expenses for the period (i.e. the sum of profit or loss and income and expenses recognised directly in equity) in the statement of changes in equity (paragraphs 96(b) and (c));
- missing or inappropriate accounting policies and note disclosures (paragraph 108);
- failure to disclose the judgements management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements; (paragraph 113); and
- failure to disclose the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year; (paragraph 116).

Amendment to HKAS 1 Presentation of Financial Statements – Capital Disclosure becomes effective for annual periods beginning on or after 1 January 2007 and requires extensive disclosures on information that enables users of financial statements to evaluate the entity's objectives, policies and processes for managing capital. These disclosures are based on the information provided internally to the entity's key management personnel. To rise successfully to this challenge members need to plan ahead in order to ensure appropriate disclosure is made in the financial statements.

3. *Segment reporting*

While the quality of segment reporting disclosures was generally satisfactory, the Committee nevertheless identified a number of areas that needed to be improved.

The Committee noted instances of incorrect or inconsistent allocation of segment results and segment assets/liabilities. Paragraphs 16 to 20 of HKAS 14 Segment Reporting provide guidance on determining segment revenue, expense, result, assets and liabilities. Normally, segment liabilities do not include borrowings, liabilities related to assets that are the subject of finance leases, and other liabilities that are incurred for financing rather than operating purposes unless the segment's operations are primarily of a financial nature. Segment result represents an operating, rather than a net-of-financing, profit or loss. Further, because debt is often issued at the head-office level on an entity-wide basis, it is often not possible to directly attribute, or reasonably allocate, the interest-bearing liability to the segment.

In addition, the Committee noted cases of failure to disclose the basis of pricing inter-segment transfers and any change therein as required under paragraph 75 of HKAS 14.

4. *Revenue recognition*

It is observed that accounting policies for revenue recognition are often too general and do not give specific disclosures on the detailed recognition criteria on major activities. Certain entities only disclose standardised revenue recognition policies extracted from HKAS 18 Revenue.

Members should apply the revenue recognition principles stated in HKAS 18 to circumstances specific to the entities' mode of operation.

In determining the relevant revenue recognition policies, members are encouraged to refer to appendix to HKAS 18 which although not a comprehensive discussion of all the relevant factors that might influence the recognition of revenue, provides examples that focus on particular aspects of a transaction.

5. *Related party disclosures*

The accounting for and disclosure of transactions with related parties are other areas where there is room for improvement, particularly for smaller listed companies, which in many cases, are controlled or managed by related parties. Shareholders other than the related parties often expect full and transparent disclosure of transactions with related parties, but in some cases, the disclosures fall short.

The following disclosure omissions were commonly found:

- relationships between parents and subsidiaries, name of parent/ultimate controlling party and, if neither the parent nor the ultimate controlling party produces financial statements available for public use, the next most senior parent that produces financial statements available for public use (paragraph 12 of HKAS 24 Related Party Disclosures);
- key management personnel compensation in total and divided into certain categories (paragraph 16); and
- for related party transactions, disclosure of the following by categories: nature of related party relationship, amounts of transactions and outstanding balances with terms and guarantees, related

provisions and doubtful/bad debts expenses (paragraph 17).

6. The effects of changes in foreign exchange rates

The Committee identified some instances where the reporting entity's functional currency appeared to be inconsistent with the requirements of HKAS 21 The Effects of Changes in Foreign Exchange Rates. Paragraph 8 of HKAS 21 defines functional currency as the currency of the primary economic environment in which the entity operates, the one which the entity normally generates and expends cash. Members are advised to refer to paragraphs 9 to 14 of HKAS 21 for further guidance on determination of functional currency, particularly noting the need to give a priority to the primary indicators set out in paragraph 9 of the Standard before considering the indicators in paragraphs 10 and 11 which are designed to provide additional supporting evidence to determine an entity's functional currency. It is, however, important to note that functional currency is a concept that applies to an entity, but not on a group basis.

7. Investments in associates

It was noted that some entities included items not forming part of investor's net investment in associates. Paragraph 29 of HKAS 28 Investments in Associates requires that "The interest in an associate is the carrying amount of the investment in the associate under the equity method together with any long-term interests (underline added) that, in substance, form part of the investor's net investment in the associate. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate. Such items may include preferred shares and long-term receivables or loans but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans".

There were instances of missing disclosures of the reasons why the presumption that an investor does not have significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, less than 20 per cent of the voting or potential voting power of the investee but concludes that it has significant influence (paragraph 37(c)); and the reasons why the presumption that an investor has significant influence is overcome if the investor holds, directly or indirectly through subsidiaries, 20 per cent or more of the voting or potential voting power of the investee but concludes that it does not have significant influence (paragraph 37(d)).

8. Impairment of assets

This topic remained one of the most common shortcomings noted during the review of financial statements.

In a number of cases the Committee questioned whether there was impairment of the carrying values of assets such as goodwill, other intangible assets, and certain investments. HKAS 36 Impairment of Assets requires financial statement preparers to undertake assessments of whether the carrying value of asset is recoverable. Based on its review, the Committee believes that some preparers of financial statements are not making the assessments with the required rigour and that some auditors are not insisting that they do so. The Committee wants to emphasise that it is inappropriate for auditors to do impairment assessments on behalf of preparers because, if they did so, their audit independence would be impaired. Instead, they must insist the client management carries out its obligations.

Often, the events and circumstances that led to the recognition or reversal of the impairment loss were not disclosed in the financial statements in accordance with paragraph 130(a) of HKAS 36.

In addition, the Committee noted that in some cases the disclosures in relation to recoverable amounts of cash-generating units containing goodwill as required by paragraphs 134 and 135 of HKAS 36 were so superficial as to be of little value to users of financial statements.

9. *Financial instruments*

While the Committee appreciates that members have made substantial efforts in understanding and implementing HKAS 32 Financial Instruments: Disclosure and Presentation and HKAS 39 Financial Instruments: Recognition and Measurement, these Standards remained a great challenge to many preparers and auditors of financial statements.

The Committee identified recurring disclosure requirements failings relating to financial instruments. Members are reminded that HKFRS 7 Financial Instruments: Disclosures is effective for the periods beginning on or after 1 January 2007 and replaces the disclosure requirements for financial instruments that were previously included in HKAS 32 (which is renamed as HKAS 32 Financial Instruments: Presentation) and supersedes HKAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions and applies to all entities.

The following are common deficiencies noted in disclosure for financial instruments:

- the risk management policies and hedging activities (paragraphs 56 and 58 of HKAS 32; now paragraphs 22 and 23 of HKFRS 7);
- the extent and nature of financial instruments including significant terms and conditions that may affect the amount, timing and certainty of future cash flow (paragraphs 60 and 62 to 65 of HKAS 32; now paragraphs 31, 33 to 42 of HKFRS 7);
- the exposure to interest rate risk and credit risk as required by (paragraphs 67 and 76 of HKAS 32; now paragraphs 33 to 42 of HKFRS 7);

- fair values of each class of financial assets and financial liabilities (paragraph 86 of HKAS 32; now paragraph 25 of HKFRS 7); and
- the methods and assumptions applied in determining the fair values (paragraph 92 of HKAS 32; now paragraph 27 of HKFRS 7).

Members should also be aware that in accordance with paragraph 90 of HKAS 32 (now paragraph 30 of HKFRS 7) if investments in unquoted equity investments are measured at cost because their fair value cannot be measured reliably, that fact shall be disclosed together with a description of the financial instruments, their carrying amount, an explanation of why fair value cannot be measured reliably and, if possible, the range of estimates within which fair value is highly likely to lie.

In addition to the disclosure deficiencies noted above, the Committee has concerns that members might not have a thorough understanding on the presentation of convertible debt instruments in financial statements. The Committee wishes to remind members that appropriate classification is determined at initial recognition taking into account the substance of the contractual arrangement, not its legal form. Paragraph 31 of HKAS 32 requires that the value of embedded derivatives in compound financial instrument is included in the liability component when allocating the value of compound financial instrument to its equity and liability components.

The classification of convertible financial instruments into equity and liability components is more complicated if an entity issues an instrument denominated in a currency other than its functional currency. When a contractual obligation is settled by delivering a fixed number of the entity's own equity instruments for a fixed amount of cash or other financial assets denominated in a foreign currency, it is classified as liability as, whilst the latter is fixed in foreign currency terms, it resulted in receiving variable amount of cash measured in the entity's functional currency.

Other areas where the Committee raised questions to members included inappropriate offsetting of financial assets and financial liabilities and inappropriate accounting treatment in relation to transaction costs of equity transactions.

With the amendments related to financial guarantee contracts coming into force from accounting periods beginning 1 January 2006, the Committee found in some cases that the accounting treatment of financial guarantee contracts appeared not to follow the requirements set out in Amendments to HKAS 39 Financial Instruments: Recognition and Measurement & HKFRS 4 Insurance Contracts – Financial Guarantee Contracts. The Standard requires an issuer of the financial guarantee contract to recognise such contract initially at fair value and subsequently at the higher of the amount determined in accordance with HKAS 37 Provisions, Contingent Liabilities and Contingent Assets and the amount initially recognised less, where appropriate, any cumulative amortisation recognised in accordance with HKAS 18.

10. Audit opinion

In certain cases, auditors rendered qualified opinions in respect of limitation of audit scope in circumstances related to significant uncertainty where the Committee considered that an emphasis of matter paragraph referring to the uncertainty in the financial statements appeared to be more appropriate. Paragraphs 16 to 18 of HKSA 701 Modifications to the Independent Auditor's Report mentions that a limitation of scope of the auditors' work may be imposed either by the entity (e.g. where terms of engagement specify that the auditors will not carry out an audit procedures the auditor believes is necessary) or imposed by circumstances (e.g. the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). In other words, limitation of scope is usually associated with situations where evidence is reasonably expected to be available but is not given to the auditors and no other satisfactory alternative audit procedures could reasonably be performed to enable the auditors to obtain sufficient appropriate audit evidence. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but may affect the financial statements.

Members should note that when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor would ordinarily not accept such a limited engagement as an audit engagement, unless required by statute (paragraph 16 of HKSA 701).

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