



MEMBERS' HANDBOOK

Update No. 31

(Issued July 2006)

<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
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VOLUME III

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Insert revised page 1 and
discard the replaced page

HONG KONG STANDARDS ON QUALITY CONTROL (REVISED)

[HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*](#)

Insert revised HKSQC 1 and
discard the previous version

Note 1

HONG KONG STANDARDS ON AUDITING (REVISED)

[HKSA 330 *The Auditor's Procedures in Response to Assessed Risks*](#)

Insert the revised pages 1 to 2
and 11 to 16 and discard the
replaced pages

Note 2

Notes:

1. [HKSA 230, "Audit Documentation"](#) gave rise to conforming amendments to HKSQC 1. Systems of quality control in compliance with the amended HKSQC 1 are required to be established by 15 June 2006. The conforming amendments previously set out in the Appendix to HKSQC 1 (revised February 2006 under Handbook Update 26) is now incorporated in the body of this HKSQC 1, marked-up for reference. They are paragraphs 6(a) and 73a – 73l.
2. [HKSA 230, "Audit Documentation"](#) gave rise to conforming amendments to HKSA 330. The conforming amendments to HKSA 330 are effective for audits of financial statements for period beginning on or after 15 June 2006. The conforming amendments previously set out in the Appendix to HKSA 330 (revised February 2006 under Handbook Update 26) is now incorporated in the body of the HKSA 330, marked-up for reference. They are paragraphs 50, 73, 73a and 73b.

July 2006



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Effective as of 15 June 2005*

Hong Kong Standard on Quality Control 1

Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

* HKSA 230, "Audit Documentation" gave rise to conforming amendments to HKSQC 1. Systems of quality control in compliance with the amended HKSQC 1 are required to be established by 15 June 2006. The conforming amendments previously set out in the Appendix to HKSQC 1 (revised February 2006 under Handbook Update 26) is now incorporated in the body of this HKSQC 1 (revised July 2006 under Handbook Update 31), marked-up for reference. They are paragraphs 6(a) and 73a – 73l.



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

HONG KONG STANDARD ON QUALITY CONTROL 1
QUALITY CONTROL FOR FIRMS THAT PERFORM
AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION,
AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

(Effective as of 15 June 2005^{*})

(Issued October 2004, revised February 2006 and revised July 2006)

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Hong Kong Standard on Quality Control (HKSQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" should be read in the context of the "Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services" which sets out the application and authority of HKSQCs.

* HKSA 230, "Audit Documentation" gave rise to conforming amendments to HKSQC 1. Systems of quality control in compliance with the amended HKSQC 1 are required to be established by 15 June 2006. The conforming amendments previously set out in the Appendix to HKSQC 1 (revised February 2006 under Handbook Update 26) is now incorporated in the body of this HKSQC 1 (revised July 2006 under Handbook Update 31), marked-up for reference. They are paragraphs 6(a) and 73a – 73l.

Introduction

1. The purpose of this Hong Kong Standard on Quality Control (HKSQC) is to establish basic principles and essential procedures and to provide guidance regarding a firm's responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. This HKSQC is to be read in conjunction with the Code of Ethics for Professional Accountants (the Code).
2. Additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the HKICPA. HKSA 220, "Quality Control for Audits of Historical Financial Information", for example, establishes standards and provides guidance on quality control procedures for audits of historical financial information.
3. **The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.**
4. A system of quality control consists of policies designed to achieve the objectives set out in paragraph 3 and the procedures necessary to implement and monitor compliance with those policies.
5. This HKSQC applies to all firms. The nature of the policies and procedures developed by individual firms to comply with this HKSQC will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

Definitions

6. In this HKSQC, the following terms have the meanings attributed below:
 - (a) "Engagement documentation" – the record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used). The documentation for a specific engagement is assembled in an engagement file;
 - (b) "Engagement partner" – the partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body;
 - (c) "Engagement quality control review" – a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report;
 - (d) "Engagement quality control reviewer" – a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report;
 - (e) "Engagement team" – all personnel performing an engagement, including any experts contracted by the firm in connection with that engagement;
 - (f) "Firm" – a sole practitioner, partnership, corporation or other entity of professional accountants;
 - (g) "Inspection" – in relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures;

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- (h) “Listed entity”^{*} – an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body;
- (i) “Monitoring” – a process comprising an ongoing consideration and evaluation of the firm’s system of quality control, including a periodic inspection of a selection of completed engagements, designed to enable the firm to obtain reasonable assurance that its system of quality control is operating effectively;
- (j) “Network firm”^{*} – an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally;
- (k) “Partner” – any individual with authority to bind the firm with respect to the performance of a professional services engagement;
- (l) “Personnel” – partners and staff;
- (m) “Professional standards” – Hong Kong Engagement Standards, as defined in the “Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services,” and relevant ethical requirements of the Code;
- (n) “Reasonable assurance” – in the context of this HKSQC, a high, but not absolute, level of assurance;
- (o) “Staff” – professionals, other than partners, including any experts the firm employs; and
- (p) “Suitably qualified external person” – an individual outside the firm with the capabilities and competence to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organization that provides relevant quality control services.

Elements of a System of Quality Control

7. **The firm’s system of quality control should include policies and procedures addressing each of the following elements:**
 - (a) **Leadership responsibilities for quality within the firm.**
 - (b) **Ethical requirements.**
 - (c) **Acceptance and continuance of client relationships and specific engagements.**
 - (d) **Human resources.**
 - (e) **Engagement performance.**
 - (f) **Monitoring.**
8. **The quality control policies and procedures should be documented and communicated to the firm’s personnel.** Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

^{*} As defined in the Code.

Leadership Responsibilities for Quality Within the Firm

9. **The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.**
10. The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasizing the firm's quality control policies and procedures, and the requirement to:
 - (a) Perform work that complies with professional standards and regulatory and legal requirements; and
 - (b) Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards high quality work. They may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They are incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.
11. Of particular importance is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overriding requirement for the firm to achieve quality in all the engagements that the firm performs. Accordingly:
 - (a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;
 - (b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion (including incentive systems) with regard to its personnel, are designed to demonstrate the firm's overriding commitment to quality; and
 - (c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.
12. **Any person or persons assigned operational responsibility for the firm's quality control system by the firm's chief executive officer or managing board of partners should have sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.**
13. Sufficient and appropriate experience and ability enables the responsible person or persons to identify and understand quality control issues and to develop appropriate policies and procedures. Necessary authority enables the person or persons to implement those policies and procedures.

Ethical Requirements

14. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.**
15. The Code establishes the fundamental principles of professional ethics, which include:
 - (a) Integrity;
 - (b) Objectivity;
 - (c) Professional competence and due care;
 - (d) Confidentiality; and

- (e) Professional behaviour.
- 16. The Code includes a conceptual approach to independence for assurance engagements that takes into account threats to independence, accepted safeguards and the public interest.
- 17. The firm's policies and procedures emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring and (d) a process for dealing with non-compliance. Independence for assurance engagements is so significant that it is addressed separately in paragraphs 18-27 below. These paragraphs need to be read in conjunction with the Code.

Independence

- 18. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Code. Such policies and procedures should enable the firm to:**
 - (a) **Communicate its independence requirements to its personnel and, where applicable, others subject to them; and**
 - (b) **Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.**
- 19. **Such policies and procedures should require:**
 - (a) **Engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements;**
 - (b) **Personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken; and**
 - (c) **The accumulation and communication of relevant information to appropriate personnel so that:**
 - (i) **The firm and its personnel can readily determine whether they satisfy independence requirements;**
 - (ii) **The firm can maintain and update its records relating to independence; and**
 - (iii) **The firm can take appropriate action regarding identified threats to independence.**
- 20. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:**
 - (a) **All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;**
 - (b) **The firm to promptly communicate identified breaches of these policies and procedures to:**
 - (i) **The engagement partner who, with the firm, needs to address the breach; and**
 - (ii) **Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and**

- (c) **Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.**
21. Comprehensive guidance on threats to independence and safeguards, including application to specific situations, is set out in the Code.
22. A firm receiving notice of a breach of independence policies and procedures promptly communicates relevant information to engagement partners, others in the firm as appropriate and, where applicable, experts contracted by the firm and network firm personnel, for appropriate action. Appropriate action by the firm and the relevant engagement partner includes applying appropriate safeguards to eliminate the threats to independence or to reduce them to an acceptable level, or withdrawing from the engagement. In addition, the firm provides independence education to personnel who are required to be independent.
23. **At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the Code.**
24. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.
25. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat. **Accordingly, the firm should establish policies and procedures:**
- (a) **Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and**
- (b) **For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.**
26. Using the same senior personnel on assurance engagements over a prolonged period may create a familiarity threat or otherwise impair the quality of performance of the engagement. Therefore, the firm establishes criteria for determining the need for safeguards to address this threat. In determining appropriate criteria, the firm considers such matters as (a) the nature of the engagement, including the extent to which it involves a matter of public interest, and (b) the length of service of the senior personnel on the engagement. Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.
27. The Code recognizes that the familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the Code requires the rotation of the engagement partner after a pre-defined period, normally no more than seven years, and provides related standards and guidance.

Acceptance and Continuance of Client Relationships and Specific Engagements

28. **The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it:**
- (a) **Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;**
- (b) **Is competent to perform the engagement and has the capabilities, time and**

resources to do so; and

(c) Can comply with ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

29. With regard to the integrity of a client, matters that the firm considers include, for example:
- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
 - The nature of the client's operations, including its business practices.
 - Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
 - Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
 - Indications of an inappropriate limitation in the scope of work.
 - Indications that the client might be involved in money laundering or other criminal activities.
 - The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

30. Information on such matters that the firm obtains may come from, for example:
- Communications with existing or previous providers of professional accountancy services to the client in accordance with the Code, and discussions with other third parties.
 - Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
 - Background searches of relevant databases.
31. In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement from a new or an existing client, the firm reviews the specific requirements of the engagement and existing partner and staff profiles at all relevant levels. Matters the firm considers include whether:
- Firm personnel have knowledge of relevant industries or subject matters;
 - Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively;
 - The firm has sufficient personnel with the necessary capabilities and competence;
 - Experts are available, if needed;
 - Individuals meeting the criteria and eligibility requirements to perform engagement quality control review are available, where applicable; and
 - The firm is able to complete the engagement within the reporting deadline.

32. The firm also considers whether accepting an engagement from a new or an existing client may give rise to an actual or perceived conflict of interest. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.
33. Deciding whether to continue a client relationship includes consideration of significant matters that have arisen during the current or previous engagements, and their implications for continuing the relationship. For example, a client may have started to expand its business operations into an area where the firm does not possess the necessary knowledge or expertise.
34. **Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:**
- (a) **The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and**
 - (b) **The possibility of withdrawing from the engagement or from both the engagement and the client relationship.**
35. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:
- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
 - If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
 - Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
 - Documenting significant issues, consultations, conclusions and the basis for the conclusions.

Human Resources

36. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.**
37. Such policies and procedures address the following personnel issues:
- Recruitment;
 - Performance evaluation;
 - Capabilities;
 - Competence;
 - Career development;

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- Promotion;
- Compensation; and
- The estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity with the capacity to develop the capabilities and competence necessary to perform the firm's work.

38. Capabilities and competence are developed through a variety of methods, including the following:
- Professional education.
 - Continuing professional development, including training.
 - Work experience.
 - Coaching by more experienced staff, for example, other members of the engagement team.
39. The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. The firm therefore emphasizes in its policies and procedures the need for continuing training for all levels of firm personnel, and provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. Where internal technical and training resources are unavailable, or for any other reason, the firm may use a suitably qualified external person for that purpose.
40. The firm's performance evaluation, compensation and promotion procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. In particular, the firm:
- (a) Makes personnel aware of the firm's expectations regarding performance and ethical principles;
 - (b) Provides personnel with evaluation of, and counseling on, performance, progress and career development; and
 - (c) Helps personnel understand that advancement to positions of greater responsibility depends, among other things, upon performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.
41. The size and circumstances of the firm will influence the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Assignment of Engagement Teams

42. **The firm should assign responsibility for each engagement to an engagement partner. The firm should establish policies and procedures requiring that:**
- (a) **The identity and role of the engagement partner are communicated to key members of client management and those charged with governance;**
 - (b) **The engagement partner has the appropriate capabilities, competence, authority and time to perform the role; and**
 - (c) **The responsibilities of the engagement partner are clearly defined and communicated to that partner.**

43. Policies and procedures include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.
44. **The firm should also assign appropriate staff with the necessary capabilities, competence and time to perform engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.**
45. The firm establishes procedures to assess its staff's capabilities and competence. The capabilities and competence considered when assigning engagement teams, and in determining the level of supervision required, include the following:
- An understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
 - An understanding of professional standards and regulatory and legal requirements.
 - Appropriate technical knowledge, including knowledge of relevant information technology.
 - Knowledge of relevant industries in which the clients operate.
 - Ability to apply professional judgment.
 - An understanding of the firm's quality control policies and procedures.

Engagement Performance

46. **The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances.**
47. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:
- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
 - Processes for complying with applicable engagement standards.
 - Processes of engagement supervision, staff training and coaching.
 - Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
 - Appropriate documentation of the work performed and of the timing and extent of the review.
 - Processes to keep all policies and procedures current.
48. It is important that all members of the engagement team understand the objectives of the work they are to perform. Appropriate team-working and training are necessary to assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.
49. Supervision includes the following:
- Tracking the progress of the engagement.
 - Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand

their instructions and whether the work is being carried out in accordance with the planned approach to the engagement.

- Addressing significant issues arising during the engagement, considering their significance and modifying the planned approach appropriately.
 - Identifying matters for consultation or consideration by more experienced engagement team members during the engagement.
50. Review responsibilities are determined on the basis that more experienced engagement team members, including the engagement partner, review work performed by less experienced team members. Reviewers consider whether:
- (a) The work has been performed in accordance with professional standards and regulatory and legal requirements;
 - (b) Significant matters have been raised for further consideration;
 - (c) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
 - (d) There is a need to revise the nature, timing and extent of work performed;
 - (e) The work performed supports the conclusions reached and is appropriately documented;
 - (f) The evidence obtained is sufficient and appropriate to support the report; and
 - (g) The objectives of the engagement procedures have been achieved.

Consultation

51. **The firm should establish policies and procedures designed to provide it with reasonable assurance that:**
- (a) **Appropriate consultation takes place on difficult or contentious matters;**
 - (b) **Sufficient resources are available to enable appropriate consultation to take place;**
 - (c) **The nature and scope of such consultations are documented; and**
 - (d) **Conclusions resulting from consultations are documented and implemented.**
52. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.
53. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. The firm seeks to establish a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.
54. Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters. Consultation procedures require consultation with those having appropriate knowledge, seniority and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical and other matters, and appropriate documentation and implementation of conclusions resulting from consultations.
55. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by (a) other firms, (b) professional and regulatory bodies, or (c) commercial organizations that provide relevant quality control services. Before contracting for such services, the firm considers whether the external provider is suitably qualified for that purpose.

56. The documentation of consultations with other professionals that involve difficult or contentious matters is agreed by both the individual seeking consultation and the individual consulted. The documentation is sufficiently complete and detailed to enable an understanding of:
- (a) The issue on which consultation was sought; and
 - (b) The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Differences of Opinion

57. **The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. Conclusions reached should be documented and implemented.**
58. Such procedures encourage identification of differences of opinion at an early stage, provide clear guidelines as to the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. **The report should not be issued until the matter is resolved.**
59. A firm using a suitably qualified external person to conduct an engagement quality control review recognizes that differences of opinion can occur and establishes procedures to resolve such differences, for example, by consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

60. **The firm should establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report. Such policies and procedures should:**
- (a) **Require an engagement quality control review for all audits of financial statements of listed entities;**
 - (b) **Set out criteria against which all other audits and reviews of historical financial information, and other assurance and related services engagements should be evaluated to determine whether an engagement quality control review should be performed; and**
 - (c) **Require an engagement quality control review for all engagements meeting the criteria established in compliance with subparagraph (b).**
61. **The firm's policies and procedures should require the completion of the engagement quality control review before the report is issued.**
62. Criteria that a firm considers when determining which engagements other than audits of financial statements of listed entities are to be subject to an engagement quality control review include the following:
- The nature of the engagement, including the extent to which it involves a matter of public interest.
 - The identification of unusual circumstances or risks in an engagement or class of engagements.
 - Whether laws or regulations require an engagement quality control review.
63. **The firm should establish policies and procedures setting out:**
- (a) **The nature, timing and extent of an engagement quality control review;**

- (b) **Criteria for the eligibility of engagement quality control reviewers; and**
- (c) **Documentation requirements for an engagement quality control review.**

Nature, Timing and Extent of the Engagement Quality Control Review

64. An engagement quality control review ordinarily involves discussion with the engagement partner, a review of the financial statements or other subject matter information and the report, and, in particular, consideration of whether the report is appropriate. It also involves a review of selected working papers relating to the significant judgments the engagement team made and the conclusions they reached. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.
65. An engagement quality control review for audits of financial statements of listed entities includes considering the following:
- The engagement team's evaluation of the firm's independence in relation to the specific engagement.
 - Significant risks identified during the engagement and the responses to those risks.
 - Judgments made, particularly with respect to materiality and significant risks.
 - Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
 - The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
 - The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
 - Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
 - The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

66. The engagement quality control reviewer conducts the review in a timely manner at appropriate stages during the engagement so that significant matters may be promptly resolved to the reviewer's satisfaction before the report is issued.
67. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report is not issued until the matter is resolved by following the firm's procedures for dealing with differences of opinion.

Criteria for the Eligibility of Engagement Quality Control Reviewers

68. **The firm's policies and procedures should address the appointment of engagement quality control reviewers and establish their eligibility through:**
- (a) **The technical qualifications required to perform the role, including the necessary experience and authority; and**
 - (b) **The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer's objectivity.**
69. The firm's policies and procedures on the technical qualifications of engagement quality control reviewers address the technical expertise, experience and authority necessary to

perform the role. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. In addition, the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

70. The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer. For example, the engagement quality control reviewer:
- (a) Is not selected by the engagement partner;
 - (b) Does not otherwise participate in the engagement during the period of review;
 - (c) Does not make decisions for the engagement team; and
 - (d) Is not subject to other considerations that would threaten the reviewer's objectivity.
71. The engagement partner may consult the engagement quality control reviewer during the engagement. Such consultation need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant, however, care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person is appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement. The firm's policies provide for the replacement of the engagement quality control reviewer where the ability to perform an objective review may be impaired.
72. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the firm follows the requirements and guidance in paragraphs 68-71.

Documentation of the Engagement Quality Control Review

73. **Policies and procedures on documentation of the engagement quality control review should require documentation that:**
- (a) **The procedures required by the firm's policies on engagement quality control review have been performed;**
 - (b) **The engagement quality control review has been completed before the report is issued; and**
 - (c) **The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.**

Engagement Documentation

Completion of the Assembly of Final Engagement Files

- 73a. **The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized.**
- 73b. Law or regulation may prescribe the time limits by which the assembly of final engagement files for specific types of engagement should be completed. Where no such time limits are prescribed in law or regulation, the firm establishes time limits appropriate to the nature of the engagements that reflect the need to complete the assembly of final engagement files on a timely basis. In the case of an audit, for example, such a time limit is ordinarily not more than 60 days after the date of the auditor's report.

73c. Where two or more different reports are issued in respect of the same subject matter information of an entity, the firm's policies and procedures relating to time limits for the assembly of final engagement files address each report as if it were for a separate engagement. This may, for example, be the case when the firm issues an auditor's report on a component's financial information for group consolidation purposes and, at a subsequent date, an auditor's report on the same financial information for statutory purposes.

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

73d. **The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation.**

73e. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

73f. Whether engagement documentation is in paper, electronic or other media, the integrity, accessibility or retrievability of the underlying data may be compromised if the documentation could be altered, added to or deleted without the firm's knowledge, or if it could be permanently lost or damaged. Accordingly, the firm designs and implements appropriate controls for engagement documentation to:

- (a) Enable the determination of when and by whom engagement documentation was created, changed or reviewed;
- (b) Protect the integrity of the information at all stages of the engagement especially when the information is shared within the engagement team or transmitted to other parties via the Internet;
- (c) Prevent unauthorized changes to the engagement documentation; and
- (d) Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

73g. Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation include, for example:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.

73h. For practical reasons, original paper documentation may be electronically scanned for inclusion in engagement files. In that case, the firm implements appropriate procedures requiring engagement teams to:

- (a) Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- (b) Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and
- (c) Enable the scanned copies to be retrieved and printed as necessary.

The firm considers whether to retain original paper documentation that has been scanned for legal, regulatory or other reasons.

Retention of Engagement Documentation

- 73i. **The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation.**
- 73j. The needs of the firm for retention of engagement documentation and the period of such retention, will vary with the nature of the engagement and the firm's circumstances, for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether local law or regulation prescribes specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the jurisdiction in the absence of specific legal or regulatory requirements. In the specific case of audit engagements, the retention period ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.
- 73k. Procedures that the firm adopts for retention of engagement documentation include those that:
- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time.
 - Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed.
 - Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Ownership of Engagement Documentation

- 73l. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.

Monitoring

74. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.**
75. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:
- (a) Adherence to professional standards and regulatory and legal requirements;

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- (b) Whether the quality control system has been appropriately designed and effectively implemented; and
 - (c) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.
76. The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility. Monitoring of the firm's system of quality control is performed by competent individuals and covers both the appropriateness of the design and the effectiveness of the operation of the system of quality control.
77. Ongoing consideration and evaluation of the system of quality control includes matters such as the following:
- Analysis of:
 - New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
 - Written confirmation of compliance with policies and procedures on independence;
 - Continuing professional development, including training; and
 - Decisions related to acceptance and continuance of client relationships and specific engagements.
 - Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
 - Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
 - Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.
78. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include at least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:
- The size of the firm.
 - The number and geographical location of offices.
 - The results of previous monitoring procedures.
 - The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
 - The nature and complexity of the firm's practice and organization.
 - The risks associated with the firm's clients and specific engagements.
79. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. Those inspecting the engagements are not involved in performing the engagement or the engagement quality control review. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an

- independent external inspection program does not act as a substitute for the firm's own internal monitoring program.
80. Small firms and sole practitioners may wish to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, they may wish to establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.
81. **The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and should determine whether they are either:**
- (a) **Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or**
 - (b) **Systemic, repetitive or other significant deficiencies that require prompt corrective action.**
82. **The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.**
83. **The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:**
- (a) **Taking appropriate remedial action in relation to an individual engagement or member of personnel;**
 - (b) **The communication of the findings to those responsible for training and professional development;**
 - (c) **Changes to the quality control policies and procedures; and**
 - (d) **Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.**
84. **Where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. It should also consider obtaining legal advice.**
85. **At least annually, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or, if appropriate, its managing board of partners. Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities. Information communicated should include the following:**
- (a) **A description of the monitoring procedures performed.**
 - (b) **The conclusions drawn from the monitoring procedures.**
 - (c) **Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.**
86. The reporting of identified deficiencies to individuals other than the relevant engagement partners ordinarily does not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

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87. Some firms operate as part of a network and, for consistency, may implement some or all of their monitoring procedures on a network basis. Where firms within a network operate under common monitoring policies and procedures designed to comply with this HKSQC, and these firms place reliance on such a monitoring system:
- (a) At least annually, the network communicates the overall scope, extent and results of the monitoring process to appropriate individuals within the network firms;
 - (b) The network communicates promptly any identified deficiencies in the quality control system to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken; and
 - (c) Engagement partners in the network firms are entitled to rely on the results of the monitoring process implemented within the network, unless the firms or the network advises otherwise.
88. Appropriate documentation relating to monitoring:
- (a) Sets out monitoring procedures, including the procedure for selecting completed engagements to be inspected;
 - (b) Records the evaluation of:
 - (i) Adherence to professional standards and regulatory and legal requirements;
 - (ii) Whether the quality control system has been appropriately designed and effectively implemented; and
 - (iii) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and
 - (c) Identifies the deficiencies noted, evaluates their effect, and sets out the basis for determining whether and what further action is necessary.

Complaints and Allegations

89. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:**
- (a) **Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and**
 - (b) **Allegations of non-compliance with the firm's system of quality control.**
90. Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties. They may be received by engagement team members or other firm personnel.
91. As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.
92. The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.
93. Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action as discussed in paragraph 83.

Documentation

94. **The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.**
95. How such matters are documented is the firm's decision. For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods such as manual notes, checklists and forms.
96. Factors to consider when determining the form and content of documentation evidencing the operation of each of the elements of the system of quality control include the following:
- The size of the firm and the number of offices.
 - The degree of authority both personnel and offices have.
 - The nature and complexity of the firm's practice and organization.
97. The firm retains this documentation for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

98. Systems of quality control in compliance with this HKSQC are required to be established by 15 June 2005 (15 June 2006 for paragraphs 6(a) and 73a – 73l). Firms consider the appropriate transitional arrangements for engagements in process at these dates.

Conformity and Compliance with International Standards on Quality Control

99. As of July 2006 (*date of revision*), this HKSQC conforms with International Standard on Quality Control (ISQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements".

Public Sector Perspective

1. *Some of the terms in HKSQC 1, such as "engagement partner" and "firm", should be read as referring to their public sector equivalents. However, with limited exceptions, there is no public sector equivalent of "listed entities", although there may be audits of particularly significant public sector entities which should be subject to the listed entity requirements of mandatory rotation of the engagement partner (or equivalent) and engagement quality control review. There are no fixed objective criteria on which this determination of significance should be based. However, such an assessment should encompass an evaluation of all factors relevant to the audited entity. Such factors include size, complexity, commercial risk, parliamentary or media interest and the number and range of stakeholders affected.*
2. *HKSQC 1, paragraph 70, states that "The firm's policies and procedures are designed to maintain the objectivity of the engagement quality control reviewer". Subparagraph (a) notes as an example that the engagement quality control reviewer is not selected by the engagement partner. However, in many jurisdictions, there is a single statutorily appointed auditor-general who acts in a role equivalent to that of "engagement partner" and who has overall responsibility for public sector audits. In such circumstances, where applicable, the engagement reviewer should be selected having regard to the need for independence and objectivity.*
3. *In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, considerations regarding the acceptance and continuance of client relationships and specific engagements, as set out in paragraphs 28-35 of HKSQC 1, may not apply.*

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4. *Similarly, the independence of public sector auditors may be protected by statutory measures, with the consequence that certain of the threats to independence of the nature envisaged by paragraphs 18-27 of HKSQC 1 are unlikely to occur.*

Effective for audits of financial statements
for periods beginning on or after 15 December 2004*

Hong Kong Standard on Auditing 330

The Auditor's Procedures in Response to Assessed Risks

* HKSA 230, "Audit Documentation" gave rise to conforming amendments to HKSA 330. The conforming amendments to HKSA 330 are effective for audits of financial statements for period beginning on or after 15 June 2006. The conforming amendments previously set out in the Appendix to HKSA 330 (revised February 2006 under Handbook Update 26) is now incorporated in the body of this HKSA 330 (revised July 2006 under Handbook Update 31), marked-up for reference. They are paragraphs 50, 73, 73a and 73b.



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

HONG KONG STANDARD ON AUDITING 330

THE AUDITOR'S PROCEDURES IN RESPONSE TO ASSESSED RISKS

(Effective for audits of financial statements
for periods beginning on or after 15 December 2004*)

(Issued November 2004; revised February 2006 and revised July 2006)

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Hong Kong Standard on Auditing (HKSA) 330, "The Auditor's Procedures in Response to Assessed Risks" should be read in the context of the "Preface to Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services" which sets out the application and authority of HKSAs.

* HKSA 230, "Audit Documentation" gave rise to conforming amendments to HKSA 330. These amendments are effective for audits of financial statements for periods beginning on or after 15 June 2006. The conforming amendments previously set out in the Appendix to HKSA 330 (revised February 2006 under Handbook Update 26) is now incorporated in the body of this HKSA 330 (revised July 2006 under Handbook Update 31), marked-up for reference. They are paragraphs 50, 73, 73a and 73b.

Introduction

1. The purpose of this Hong Kong Standard on Auditing (HKSA) is to establish standards and provide guidance on determining overall responses and designing and performing further audit procedures to respond to the assessed risks of material misstatement at the financial statement and assertion levels in a financial statement audit. The auditor's understanding of the entity and its environment, including its internal control, and assessment of the risks of material misstatement are described in HKSA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement".
2. The following is an overview of the requirements of this standard:
 - *Overall responses.* This section requires the auditor to determine overall responses to address risks of material misstatement at the financial statement level and provides guidance on the nature of those responses.
 - *Audit procedures responsive to risks of material misstatement at the assertion level.* This section requires the auditor to design and perform further audit procedures, including tests of the operating effectiveness of controls, when relevant or required, and substantive procedures, whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level. In addition, this section includes matters the auditor considers in determining the nature, timing, and extent of such audit procedures.
 - *Evaluating the sufficiency and appropriateness of audit evidence obtained.* This section requires the auditor to evaluate whether the risk assessment remains appropriate and to conclude whether sufficient appropriate audit evidence has been obtained.
 - *Documentation.* This section establishes related documentation requirements.
3. **In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level.** The overall responses and the nature, timing, and extent of the further audit procedures are matters for the professional judgment of the auditor. In addition to the requirements of this HKSA, the auditor also complies with the requirements and guidance in HKSA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" in responding to assessed risks of material misstatement due to fraud.

Overall Responses

4. **The auditor should determine overall responses to address the risks of material misstatement at the financial statement level.** Such responses may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with special skills or using experts,¹ providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.
5. The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at period end. If there are weaknesses in the control environment, the auditor ordinarily conducts more audit procedures as of the period end rather than at an interim date, seeks more extensive audit evidence from substantive procedures, modifies the nature of audit procedures to obtain more

¹ The assignment of engagement personnel to the particular engagement reflects the auditor's risk assessment, which is based on the auditor's understanding of the entity.

persuasive audit evidence, or increases the number of locations to be included in the audit scope.

6. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

Audit Procedures Responsive to Risks of Material Misstatement at the Assertion Level

7. **The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level.** The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessment. In designing further audit procedures, the auditor considers such matters as the following:
 - The significance of the risk.
 - The likelihood that a material misstatement will occur.
 - The characteristics of the class of transactions, account balance, or disclosure involved.
 - The nature of the specific controls used by the entity and in particular whether they are manual or automated.
 - Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing, or detecting and correcting, material misstatements.

The nature of the audit procedures is of most importance in responding to the assessed risks.

8. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion. In other cases, the auditor may determine that performing only substantive procedures is appropriate for specific assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertion would be effective in reducing the risk of material misstatement to an acceptably low level. Often the auditor may determine that a combined approach using both tests of the operating effectiveness of controls and substantive procedures is an effective approach. Irrespective of the approach selected, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure as required by paragraph 49.
9. In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor's further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in paragraph 8 above, the auditor considers whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Considering the Nature, Timing, and Extent of Further Audit Procedures

Nature

10. The nature of further audit procedures refers to their purpose (tests of controls or substantive procedures) and their type, that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedures. Certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

11. The auditor's selection of audit procedures is based on the assessment of risk. The higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. This may affect both the types of audit procedures to be performed and their combination. For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document.
12. In determining the audit procedures to be performed, the auditor considers the reasons for the assessment of the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure. This includes considering both the particular characteristics of each class of transactions, account balance, or disclosure (i.e., the inherent risks) and whether the auditor's risk assessment takes account of the entity's controls (i.e., the control risk). For example, if the auditor considers that there is a lower risk that a material misstatement may occur because of the particular characteristics of a class of transactions without consideration of the related controls, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there is a lower risk that a material misstatement may arise because an entity has effective controls and the auditor intends to design substantive procedures based on the effective operation of those controls, then the auditor performs tests of controls to obtain audit evidence about their operating effectiveness. This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.
13. The auditor is required to obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit procedures. For example, if the auditor uses non-financial information or budget data produced by the entity's information system in performing audit procedures, such as substantive analytical procedures or tests of controls, the auditor obtains audit evidence about the accuracy and completeness of such information. See HKSA 500, "Audit Evidence" paragraph 11 for further guidance.

Timing

14. Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies.
15. The auditor may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters. If the auditor performs tests of controls or substantive procedures prior to period end, the auditor considers the additional evidence required for the remaining period (see paragraphs 37-38 and 56-61).
16. In considering when to perform audit procedures, the auditor also considers such matters as the following:
 - The control environment.
 - When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
 - The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
 - The period or date to which the audit evidence relates.
17. Certain audit procedures can be performed only at or after period end, for example, agreeing the financial statements to the accounting records and examining adjustments made during

the course of preparing the financial statements. If there is a risk that the entity may have entered into improper sales contracts or transactions may not have been finalized at period end, the auditor performs procedures to respond to that specific risk. For example, when transactions are individually material or an error in cutoff may lead to a material misstatement, the auditor ordinarily inspects transactions near the period end.

Extent

18. Extent includes the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. In particular, the auditor ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk; therefore, the nature of the audit procedure is the most important consideration.
19. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.
20. Valid conclusions may ordinarily be drawn using sampling approaches. However, if the quantity of selections made from a population is too small, the sampling approach selected is not appropriate to achieve the specific audit objective, or if exceptions are not appropriately followed up, there will be an unacceptable risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure. HKSA 530, "Audit Sampling and Other Means of Testing" contains guidance on the use of sampling.
21. This standard regards the use of different audit procedures in combination as an aspect of the nature of testing as discussed above. However, the auditor considers whether the extent of testing is appropriate when performing different audit procedures in combination.

Tests of Controls

22. The auditor is required to perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.
23. **When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.** See paragraphs 39-44 below for discussion of using audit evidence about the operating effectiveness of controls obtained in prior audits.
24. The auditor's assessment of risk of material misstatement at the assertion level may include an expectation of the operating effectiveness of controls, in which case the auditor performs tests of controls to obtain audit evidence as to their operating effectiveness. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. Paragraphs 104-106 of HKSA 315 discuss the identification of controls at the assertion level likely to prevent, or detect and correct, a material misstatement in a class of transactions, account balance or disclosure.
25. **When, in accordance with paragraph 115 of HKSA 315, the auditor has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness.** For example, as discussed in paragraph 115 of HKSA 315, the auditor may find it impossible to design effective substantive

procedures that by themselves provide sufficient appropriate audit evidence at the assertion level when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system.

26. Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor determines that the relevant controls exist and that the entity is using them. When performing tests of the operating effectiveness of controls, the auditor obtains audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor considers each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.
27. Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, and may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In such circumstances, the auditor considers whether the audit evidence provided by those audit procedures is sufficient.

Nature of Tests of Controls

28. The auditor selects audit procedures to obtain assurance about the operating effectiveness of controls. As the planned level of assurance increases, the auditor seeks more reliable audit evidence. In circumstances when the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor ordinarily performs tests of controls to obtain a higher level of assurance about their operating effectiveness.
29. **The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls.** Although different from obtaining an understanding of the design and implementation of controls, tests of the operating effectiveness of controls ordinarily include the same types of audit procedures used to evaluate the design and implementation of controls, and may also include reperformance of the application of the control by the auditor. Since inquiry alone is not sufficient, the auditor uses a combination of audit procedures to obtain sufficient appropriate audit evidence regarding the operating effectiveness of controls. Those controls subject to testing by performing inquiry combined with inspection or reperformance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation. For example, an auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor ordinarily supplements the observation with inquiries of entity personnel, and may also inspect documentation about the operation of such controls at other times during the audit period in order to obtain sufficient appropriate audit evidence.
30. The nature of the particular control influences the type of audit procedure required to obtain audit evidence about whether the control was operating effectively at relevant times during the period under audit. For some controls, operating effectiveness is evidenced by documentation. In such circumstances, the auditor may decide to inspect the documentation

to obtain audit evidence about operating effectiveness. For other controls, however, such documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

31. In designing tests of controls, the auditor considers the need to obtain audit evidence supporting the effective operation of controls directly related to the assertions as well as other indirect controls on which these controls depend. For example, the auditor may identify a user review of an exception report of credit sales over a customer's authorized credit limit as a direct control related to an assertion. In such cases, the auditor considers the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report (for example, the general IT-controls).
32. In the case of an automated application control, because of the inherent consistency of IT processing, audit evidence about the implementation of the control, when considered in combination with audit evidence obtained regarding the operating effectiveness of the entity's general controls (and in particular, change controls) may provide substantial audit evidence about its operating effectiveness during the relevant period.
33. When responding to the risk assessment, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. The objective of tests of controls is to evaluate whether a control operated effectively. The objective of tests of details is to detect material misstatements at the assertion level. Although these objectives are different, both may be accomplished concurrently through performance of a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. The auditor carefully considers the design and evaluation of such tests to accomplish both objectives.
34. The absence of misstatements detected by a substantive procedure does not provide audit evidence that controls related to the assertion being tested are effective. However, misstatements that the auditor detects by performing substantive procedures are considered by the auditor when assessing the operating effectiveness of related controls. A material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control, which is communicated to management and those charged with governance.

Timing of Tests of Controls

35. The timing of tests of controls depends on the auditor's objective and determines the period of reliance on those controls. If the auditor tests controls at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time. However, if the auditor tests controls throughout a period, the auditor obtains audit evidence of the effectiveness of the operation of the controls during that period.
36. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor requires audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient and the auditor supplements those tests with other tests of controls that are capable of providing audit evidence that the control operated effectively at relevant times during the period under audit. Such other tests may consist of tests of the entity's monitoring of controls.
37. **When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period.** In making that determination, the auditor considers the significance of the assessed risks of material misstatement at the assertion level, the specific controls that were tested during the interim period, the degree to which

- audit evidence about the operating effectiveness of those controls was obtained, the length of the remaining period, the extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls, and the control environment. The auditor obtains audit evidence about the nature and extent of any significant changes in internal control, including changes in the information system, processes, and personnel that occur subsequent to the interim period.
38. Additional audit evidence may be obtained, for example, by extending the testing of the operating effectiveness of controls over the remaining period or testing the entity's monitoring of controls.
 39. **If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls.** Paragraph 23 of HKSA 500 states that the auditor performs audit procedures to establish the continuing relevance of audit evidence obtained in prior periods when the auditor plans to use the audit evidence in the current period. For example, in performing the prior audit, the auditor may have determined that an automated control was functioning as intended. The auditor obtains audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning, for example, through inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.
 40. **If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit.** Changes may affect the relevance of the audit evidence obtained in prior periods such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of prior period audit evidence; however, a change that causes data to be accumulated or calculated differently does affect it.
 41. **If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit.** As indicated in paragraphs 40 and 44, the auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that have changed since they were last tested or controls that mitigate a significant risk. The auditor's decision on whether to rely on audit evidence obtained in prior audits for other controls is a matter of professional judgment. In addition, the length of time period between retesting such controls is also a matter of professional judgment, but cannot exceed two years.
 42. In considering whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in prior audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor considers the following:
 - The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process.
 - The risks arising from the characteristics of the control, including whether controls are manual or automated (see HKSA 315, paragraphs 57-63 for a discussion of specific risks arising from manual and automated elements of a control).
 - The effectiveness of general IT-controls.
 - The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control from tests of operating effectiveness in prior audits.

- Whether the lack of a change in a particular control poses a risk due to changing circumstances.
- The risk of material misstatement and the extent of reliance on the control.

In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that ordinarily decrease the period for retesting a control, or result in not relying on audit evidence obtained in prior audits at all, include the following:

- A weak control environment.
 - Weak monitoring of controls.
 - A significant manual element to the relevant controls.
 - Personnel changes that significantly affect the application of the control.
 - Changing circumstances that indicate the need for changes in the control.
 - Weak general IT-controls.
43. **When there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of some controls each audit.** The purpose of this requirement is to avoid the possibility that the auditor might apply the approach of paragraph 41 to all controls on which the auditor proposes to rely, but test all those controls in a single audit period with no testing of controls in the subsequent two audit periods. In addition to providing audit evidence about the operating effectiveness of the controls being tested in the current audit, performing such tests provides collateral evidence about the continuing effectiveness of the control environment and therefore contributes to the decision about whether it is appropriate to rely on audit evidence obtained in prior audits. Therefore, when the auditor determines in accordance with paragraphs 39-42 that it is appropriate to use audit evidence obtained in prior audits for a number of controls, the auditor plans to test a sufficient portion of the controls in that population in each audit period, and at a minimum, each control is tested at least every third audit.
44. **When, in accordance with paragraph 108 of HKSA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period.** The greater the risk of material misstatement, the more audit evidence the auditor obtains that relevant controls are operating effectively. Accordingly, although the auditor often considers information obtained in prior audits in designing tests of controls to mitigate a significant risk, the auditor does not rely on audit evidence obtained in a prior audit about the operating effectiveness of controls over such risks, but instead obtains the audit evidence about the operating effectiveness of controls over such risks in the current period.

Extent of Tests of Controls

45. The auditor designs tests of controls to obtain sufficient appropriate audit evidence that the controls operated effectively throughout the period of reliance. Matters the auditor may consider in determining the extent of the auditor's tests of controls include the following:
- The frequency of the performance of the control by the entity during the period.
 - The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
 - The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the assertion level.
 - The extent to which audit evidence is obtained from tests of other controls related to the assertion.

- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control).
 - The expected deviation from the control.
46. The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls. In addition, as the rate of expected deviation from a control increases, the auditor increases the extent of testing of the control. However, the auditor considers whether the rate of expected deviation indicates that the control will not be sufficient to reduce the risk of material misstatement at the assertion level to that assessed by the auditor. If the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective.
47. Because of the inherent consistency of IT processing, the auditor may not need to increase the extent of testing of an automated control. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor considers performing tests to determine that the control continues to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls are effective. Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

Substantive Procedures

48. Substantive procedures are performed in order to detect material misstatements at the assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The auditor plans and performs substantive procedures to be responsive to the related assessment of the risk of material misstatement.
49. **Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure.** This requirement reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control including management override. Accordingly, while the auditor may determine that the risk of material misstatement may be reduced to an acceptably low level by performing only tests of controls for a particular assertion related to a class of transactions, account balance or disclosure (see paragraph 8), the auditor always performs substantive procedures for each material class of transactions, account balance, and disclosure.
50. **The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:**
- **Agreeing or reconciling the financial statements with ~~to~~ the underlying accounting records; and**
 - **Examining material journal entries and other adjustments made during the course of preparing the financial statements.**

The nature and extent of the auditor's examination of journal entries and other adjustments depends on the nature and complexity of the entity's financial reporting process and the associated risks of material misstatement.

51. **When, in accordance with paragraph 108 of HKSA 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk.** For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmations not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmations with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.
52. When the approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of tests of details only, or a combination of tests of details and substantive analytical procedures. The auditor considers the guidance in paragraphs 53-64 in designing the nature, timing, and extent of substantive procedures for significant risks. In order to obtain sufficient appropriate audit evidence, the substantive procedures related to significant risks are most often designed to obtain audit evidence with high reliability.

Nature of Substantive Procedures

53. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain assertions about account balances, including existence and valuation. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the risk of material misstatement to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the assessed risk of material misstatement for a class of transactions where the auditor's assessment of risk is supported by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that only tests of details are appropriate, or that a combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
54. The auditor designs tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor selects from items contained in a financial statement amount and obtains the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor selects from audit evidence indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included. For example, the auditor might inspect subsequent cash disbursements to determine whether any purchases had been omitted from accounts payable.
55. In designing substantive analytical procedures, the auditor considers such matters as the following:
- The suitability of using substantive analytical procedures given the assertions.
 - The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.
 - Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.
 - The amount of any difference in recorded amounts from expected values that is acceptable.

The auditor considers testing the controls, if any, over the entity's preparation of information used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor considers the guidance in paragraph 11 of HKSA 500.

Timing of Substantive Procedures

56. **When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.**
57. In some circumstances, substantive procedures may be performed at an interim date. This increases the risk that misstatements that may exist at the period end are not detected by the auditor. This risk increases as the remaining period is lengthened. In considering whether to perform substantive procedures at an interim date, the auditor considers such factors as the following:
- The control environment and other relevant controls.
 - The availability of information at a later date that is necessary for the auditor's procedures.
 - The objective of the substantive procedure.
 - The assessed risk of material misstatement.
 - The nature of the class of transactions or account balance and related assertions.
 - The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that exist at period end are not detected.
58. Although the auditor is not required to obtain audit evidence about the operating effectiveness of controls in order to have a reasonable basis for extending audit conclusions from an interim date to the period end, the auditor considers whether performing only substantive procedures to cover the remaining period is sufficient. If the auditor concludes that substantive procedures alone would not be sufficient, tests of the operating effectiveness of relevant controls are performed or the substantive procedures are performed as of the period end.
59. In circumstances where the auditor has identified risks of material misstatement due to fraud, the auditor's response to address those risks may include changing the timing of audit procedures. For example, the auditor might conclude that, given the risks of intentional misstatement or manipulation, audit procedures to extend audit conclusions from an interim date to the period end would not be effective. In such circumstances, the auditor might conclude that substantive procedures need to be performed at or near the end of the reporting period to address an identified risk of material misstatement due to fraud (see HKSA 240).
60. Ordinarily, the auditor compares and reconciles information concerning the balance at the period end with the comparable information at the interim date to identify amounts that appear unusual, investigates any such amounts, and performs substantive analytical procedures or tests of details to test the intervening period. When the auditor plans to perform substantive analytical procedures with respect to the intervening period, the auditor considers whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition. The auditor considers whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate. In addition, the auditor considers whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:

significant unusual transactions or entries (including those at or near period end); other causes of significant fluctuations, or expected fluctuations that did not occur; and changes in the composition of the classes of transactions or account balances. The substantive procedures related to the remaining period depend on whether the auditor has performed tests of controls.

61. If misstatements are detected in classes of transactions or account balances at an interim date, the auditor ordinarily modifies the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or extends or repeats such audit procedures at the period end.
62. The use of audit evidence from the performance of substantive procedures in a prior audit is not sufficient to address a risk of material misstatement in the current period. In most cases, audit evidence from the performance of substantive procedures in a prior audit provides little or no audit evidence for the current period. In order for audit evidence obtained in a prior audit to be used in the current period as substantive audit evidence, the audit evidence and the related subject matter must not fundamentally change. An example of audit evidence obtained from the performance of substantive procedures in a prior period that may be relevant in the current year is a legal opinion related to the structure of a securitization to which no changes have occurred during the current period. As required by paragraph 23 of HKSA 500, if the auditor plans to use audit evidence obtained from the performance of substantive procedures in a prior audit, the auditor performs audit procedures during the current period to establish the continuing relevance of the audit evidence.

Extent of the Performance of Substantive Procedures

63. The greater the risk of material misstatement, the greater the extent of substantive procedures. Because the risk of material misstatement takes account of internal control, the extent of substantive procedures may be increased as a result of unsatisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
64. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the risk of material misstatement. However, the auditor also considers other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing representative sampling or stratifying the population into homogeneous subpopulations for sampling. HKSA 530 contains guidance on the use of sampling and other means of selecting items for testing. In designing substantive analytical procedures, the auditor considers the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by materiality and the consistency with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor increases the desired level of assurance as the risk of material misstatement increases. HKSA 520, "Analytical Procedures" contains guidance on the application of analytical procedures during an audit.

Adequacy of Presentation and Disclosure

65. **The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with the applicable financial reporting framework.** The auditor considers whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information. The presentation of financial statements in conformity with the applicable financial reporting framework also includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. The auditor considers whether management should have

disclosed a particular matter in light of the circumstances and facts of which the auditor is aware at the time. In performing the evaluation of the overall presentation of the financial statements, including the related disclosures, the auditor considers the assessed risk of material misstatement at the assertion level. See paragraph 17 of HKSA 500 for a description of the assertions related to presentation and disclosure.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

66. **Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.**
67. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing, or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a material weakness in internal control. In addition, analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement. In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. Paragraph 119 of HKSA 315 contains further guidance on revising the auditor's risk assessment.
68. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When such deviations are detected during the performance of tests of controls, the auditor makes specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions. The auditor determines whether the tests of controls performed provide an appropriate basis for reliance on the controls, whether additional tests of controls are necessary, or whether the potential risks of misstatement need to be addressed using substantive procedures.
69. The auditor cannot assume that an instance of fraud or error is an isolated occurrence, and therefore considers how the detection of a misstatement affects the assessed risks of material misstatement. Before the conclusion of the audit, the auditor evaluates whether audit risk has been reduced to an acceptably low level and whether the nature, timing, and extent of the audit procedures may need to be reconsidered. For example, the auditor reconsiders the following:
- The nature, timing, and extent of substantive procedures.
 - The audit evidence of the operating effectiveness of relevant controls, including the entity's risk assessment process.
70. **The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk of material misstatement in the financial statements.** In developing an opinion, the auditor considers all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.
71. The sufficiency and appropriateness of audit evidence to support the auditor's conclusions throughout the audit are a matter of professional judgment. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:
- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
 - Effectiveness of management's responses and controls to address the risks.

- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including its internal control.

72. **If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor should attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.**

Documentation

73. **The auditor should document the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level, and the results of those audit procedures, including the conclusions where these are not otherwise clear. In addition, if the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should document the conclusions reached with regard to relying on such controls that were tested in a prior audit. The manner in which these matters are documented is based on the auditor's professional judgement. HKSA 230, "Documentation" establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.**

73a. **The auditor's documentation should demonstrate that the financial statements agree or reconcile with the underlying accounting records.**

73b. The manner in which the matters referred to in paragraphs 73 and 73a are documented is based on the auditor's professional judgement. HKSA 230, "Audit Documentation" establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

Effective Date

74. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2004. The conforming amendments to HKSA 330 (paragraphs 50, 73, 73a and 73b) as a result of HKSA 230 "Audit Documentation" are effective for audits of financial statements for periods beginning on or after 15 June 2006.

Conformity and Compliance with International Standards on Auditing

75. As of July 2006 (*date of revision*), this HKSA conforms with International Standard on Auditing (ISA) 330, "The Auditor's Procedures in Response to Assessed Risks". Compliance with the requirements of this HKSA ensures compliance with ISA 330.

Public Sector Perspective

1. *When carrying out audits of public sector entities, the auditor takes into account the legislative framework and any other relevant regulations, ordinances or ministerial directives that affect the audit mandate and any other special auditing requirements. Such factors might affect, for example, the extent of the auditor's discretion in establishing materiality and judgments on the nature and scope of audit procedures to be applied. Paragraph 3 of this HKSA may have to be applied only after giving consideration to such restrictions.*