

JUNE 2011 SUPPLEMENT

Qualification Programme

Module C

Business Assurance



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

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## Introduction

This Supplement has been produced for those candidates preparing for the June 2011 examination session of the HKICPA Qualification Programme.

It is designed to be used in conjunction with the 2010 edition of the Learning Pack, and it will bring you fully up to date for developments that have occurred in the period since publication of the Learning Pack and 28 December 2010, the cut-off date for examinable standards and legislation for the June 2011 examination.

The supplement contains two sections:

**Part A** contains a list of any notified errors in the material in the current edition of the Learning Pack. These are identified in chapter order, therefore as you start a new chapter in the Learning Pack you are advised to refer to the list to see whether there is anything relevant. If there is no reference to a chapter, there is no error within it.

**Part B** comprises a technical update on developments that will be examinable in June 2011 that are not currently covered in the Learning Pack. The topics covered are listed on the contents page, and again are covered in chapter order.

In each case the text in the supplement explains how the Learning Pack is affected by the change, for example whether the new material should be read in addition to the current material in the Learning Pack, or whether the new material should be regarded as a replacement.

Careful study of both the Learning Pack and this supplement should ensure that you are fully prepared for the June 2011 examination session.

Good luck with your studies!

## Part A: Identified Errata

At the time of writing there are no identified errata in the Module C Learning Pack or Flashcards.

## Part B: Technical Update

### Chapters 1 to 3 **Scope of corporate governance**

#### **Corporate governance reports and practice**

##### **Internal assurance**

The UK Combined Code has been revised and in May 2010 the revisions had the effect of changing the name of the code to the UK Corporate Governance Code.

Where you see the reference in Chapters 1 to 3 of your Learning Pack, you should amend the reference to the UK Corporate Governance Code.

The UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. The UK Corporate Governance Code will be applied to financial years beginning or after 29 June 2010

### Chapter 4 **Code of Ethics for Professional Accountants (Revised)**

The Code has been revised to clarify the requirements for all professional accountants and significantly strengthen the independence requirements of auditors. The Revised Code is effective from 1 January 2011.

The existing HKICPA Code of Ethics for Professional Accountants and S290 (Revised) on independence in audit and review engagements are updated to reflect the fact that they will be superseded by the revised Code as mentioned in Note 1 on 1 January 2011.

Chapter 4 of your Learning Pack is superseded by a new version of the chapter reflecting all of the amendments. You should read the new version of chapter 4 set out as an Appendix to this Supplement, rather than the version included in the 2010 edition of the Learning Pack.

### Chapter 7 **Changes in auditor appointment**

You need to be familiar with Appendix 1 of HKSA 210 (Clarified). This should be inserted at the end of Chapter 7 of the Learning Pack.

The full text of the Appendix is reproduced as Appendix 2 at the end of this Supplement.

### Chapter 13 **Specific audit procedures**

You should add the text set out below on unreliable responses to section 4.5.3 of Chapter 13 of the Learning Pack.

#### ***Unreliable Responses***

When the auditor concludes that a response is unreliable, the auditor may need to revise the assessment of the risks of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with HKSA 315 (Clarified). For example, an unreliable response may indicate a fraud risk factor that requires evaluation in accordance with HKSA 240 (Clarified).

## Chapter 19 Audit-related services and other assurance engagements

HKSAE 3402 *Assurance Reports on Controls at a Service Organisation* is now effective for periods ending on or after 15 June 2011. You should insert the text after Section 2.1.2 in Chapter 19 of your Learning Pack.

HKSAE 3402 deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organisation that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. This HKSAE is effective for service auditors' assurance reports covering periods ending on or after 15 June 2011 with early adoption permissible.

This HKSAE applies only when the service organisation is responsible for, or otherwise able to make an assertion about, the suitable design of controls.

In addition to issuing an assurance report on controls, a service auditor may also be engaged to provide reports such as the following, which are not dealt with in this HKSAE:

- (a) A report on a user entity's transactions or balances maintained by a service organisation; or
- (b) An agreed-upon procedures report on controls at a service organisation.

Many students work in local firms and will be involved in the Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS)

PN 900 (Clarified) has been issued. You should add the new section 7 set out as Appendix 3 of this Supplement to Chapter 19 in your Learning Pack.

## Chapter 20 Information technology

PN 1001 "*IT Environments-Stand-alone personal computers*", PN 1002 "*IT Environments – On-line Computer Systems*", PN 1003 "*IT Environments – Database Systems*" and PN 1009 "*Computer-Assisted Audit Techniques*" are withdrawn as the corresponding International Auditing Practice Statements 1001, 1002, 1003 and 1009 had been withdrawn.

You should amend sections 4, 5 and 6 in Chapter 20 of your Learning Pack.

# Appendix 1: Revised Chapter 4



## chapter 4

# Code of Ethics

### Topic list

- 1 Fundamental principles and the conceptual framework approach
- 2 Specific guidance: Independence
- 3 Specific guidance: Confidentiality
- 4 Specific guidance: Conflicts of interest
- 5 Conflicts in application of the fundamental principles
- 6 Other issues

### Learning focus

Professional accountants are sometimes faced by ethical dilemmas. Codes of ethics, such as that issued by the Hong Kong Institute of Certified Public Accountants, give guiding principles to help professional accountants carry out their responsibilities to both their profession and the wider public.

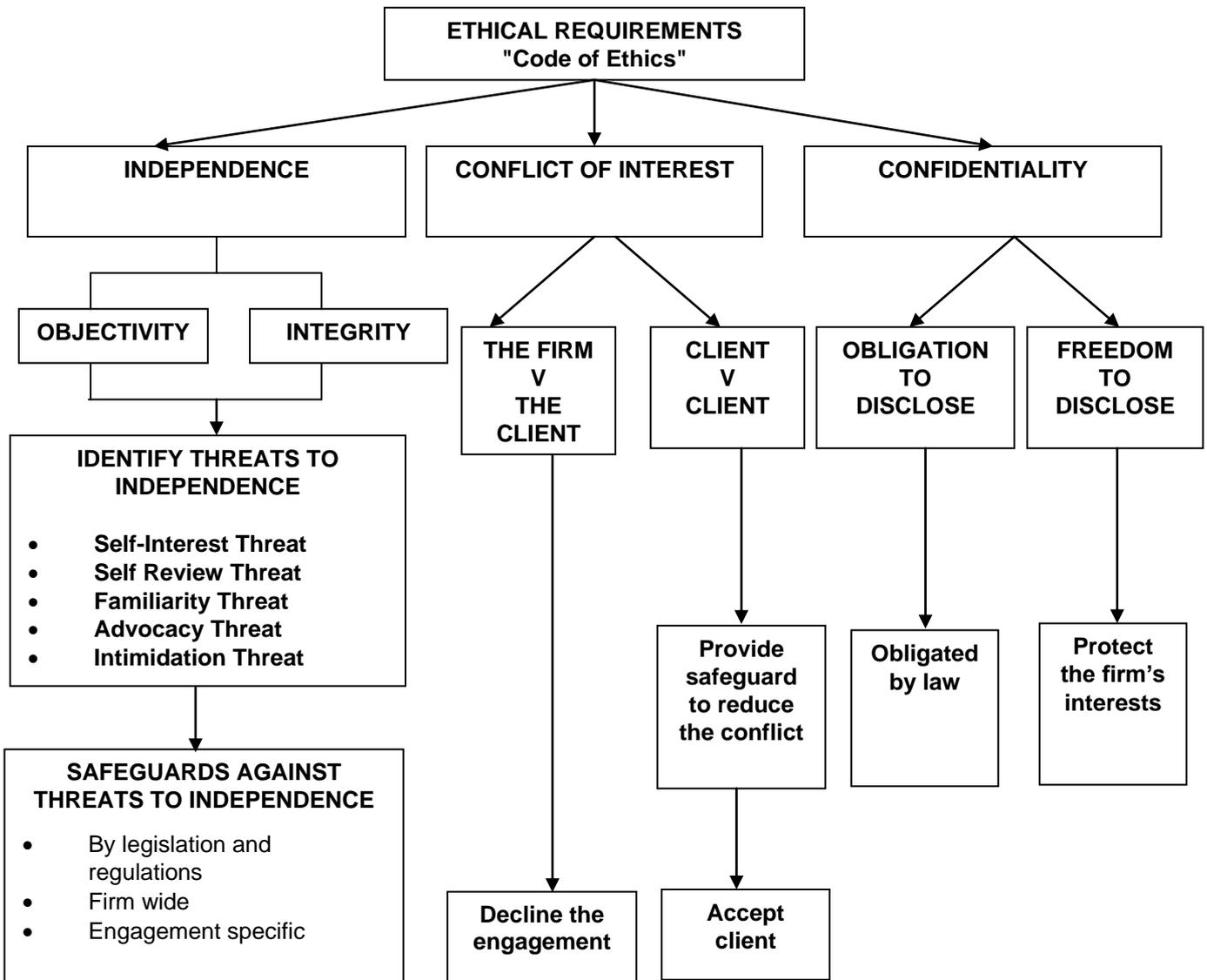
There are also a number of practical measures (safeguards) that a firm may implement to ensure that these ethical principles are not breached.

**Learning outcomes**

In this chapter you will cover the following learning outcomes:

		Competency level
<b>1.01</b>	<b>The Institute's Code of Ethics for Professional Accountants</b>	3
1.01.01	Explain the fundamental principles and the conceptual framework approach	
1.01.02	Identify, evaluate and respond to threats to compliance with the fundamental principles	
1.01.03	Discuss and evaluate the effectiveness of available safeguards	
1.01.04	Recognize and advise on conflicts in the application of fundamental principles for Professional Accountants in public practice and in business	

The following summary illustrates the main parts of the chapter:



It is important that you understand the topic well. Auditors are subject to ethical requirements imposed by the accountancy bodies; in Hong Kong, it is the HKICPA.

### Code of Ethics for Professional Accountants Revised June 2010

This Code of Ethics for Professional Accountants (the Code) is effective on 1 January 2011. It replaces the version issued in December 2005 which is effective from 30 June 2006 until 31 December 2010

All Professional accountants are required to comply with the Code .

Section A – **GENERAL APPLICATION OF THE CODE**

Section B – **PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE**

Section C – **PROFESSIONAL ACCOUNTANTS IN BUSINESS**

Section D – **ADDITIONAL ETHICAL REQUIREMENTS**

	<i>Professional Accountant in Public Practice</i>	<i>Professional Accountant in Business</i>
Definition	Professional accountant in a firm that provides professional services	Professional accountant employed or engaged in an executive or non-executive capacity ie commerce, industry, service etc
Adoption of the Part of the Code	A,B,D of the Code	A,C D of the Code

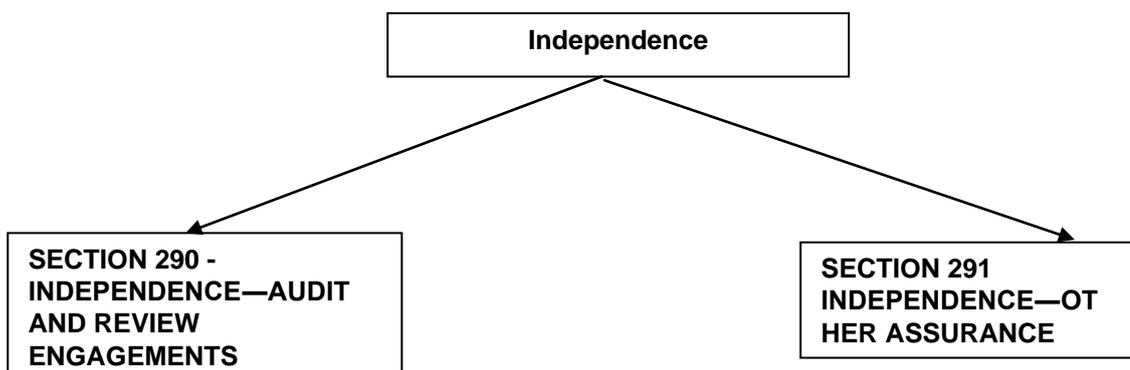
### SUMMARY OF THE MAIN CHANGES IN THE CODE

The Code of Ethics has been revised so that it is more consistent with the Clarity project in order to make the Code clearer to users :

The following are the main changes in the Code :

- (i) The threat to independence should be **reduced to an acceptable level**
- (ii) The threats to independence have been given revised descriptions and examples

#### (a) The Structure of the Code has been changed by dividing it into two parts



#### (b) 'Listed Entities' versus 'Public Interest Entities'

- The revised Code suggests that **public interest entities** are :
  - listed entities
  - an entity defined by regulation or legislation as a public interest entity

- an entity that is required by **legislation or regulation** to have an audit that is as independent as an audit of a listed entity would be; and
- any other entity that the firm determines to be a public interest entity as it has a large number and wide range of stakeholders

**(c) Documentation**

Additional guidance is given on what firms are required to **document** to support their conclusions regarding **compliance with independence requirements**.

**(d) Merger or acquisition**

New guidance has been established when a firm unexpectedly becomes related to an audit client as a result of a merger or an acquisition.

A new section has been included on the **'Management responsibilities'** that a firm must not assume in respect of an audit client.

**Specific guidance** is provided relating to an audit firm providing **internal audit services** to an audit client that is a public interest entity.

**Recurring internal audit services** must not be provided if they relate to :

- a significant part of the internal controls over the financial reporting
- amounts or disclosures which are material to the financial statements
- financial accounting systems generating significant information to the financial statements

**(e) Partner rotation**

**'Partner rotation'** is now applied to **all key audit partners** , applying to any partner making key decisions and judgments on significant audit matters.

**(f) Joining public interest audit clients**

There is now a mandatory **'cooling off'** period which applies before key audit partners can join public interest audit clients in specific positions.

**(g) Non-audit services**

The provision of **valuation services, recruiting senior management, the provision of corporate services and the provision of IT system services** are being monitored with much stricter guidance. The Code now specifically prohibits an audit firm from assuming **management responsibilities** for an audit client.

Firms are not prohibited from providing services to public interest entities where the services relate to material areas to the financial statements. For example, internal control of the IT system or valuation of an asset.

**(h) Tax services**

There are now more guidelines on tax services as, in principle, providing tax services could create a threat to independence when there is heavy tax planning involved in an audit client,

Audit firms should not prepare **material tax calculations** for an audit client which is a public interest entity except in rare situations.

**(i) Fees for public interest entity**

The revised Code emphasises that where a firm has an audit client which is a public interest entity and, **for two consecutive years**, the total fees from the client and its related entities represent **more than 15%** of the total fees, the firm shall :

- discuss that fact with the audit committee ; and
- call out engagement quality control reviews by an independent accountant

**(j) Key audit partners**

The Code reinforces that key audit partners are not permitted to be evaluated on or compensated for selling non-assurance services to their audit clients

**(k) Network**

This is defined as a larger structure:

- (a) that is aimed at co-operation; and
- (b) that is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional resources

## SECTION A

### SECTION A OF CODE OF ETHICS

Section A provides **guidance on fundamental ethical principles** where professional accountants are required to apply this conceptual framework to **identify threats** to compliance with the fundamental principles, to **evaluate the significance** of such threats and the **safeguards** to eliminate them or reduce the threats to acceptable levels.

## 1 Fundamental principles and the conceptual framework approach



### Topic highlights

Professional accountants rely on the guidance of an ethical code because they hold positions of trust, and people rely on them. In their business dealings they may encounter situations or be put under pressure to act in ways that further their own advantage, or that of an entity, against the wider public interest or the interest of their profession.

### 1.1 The importance of ethics

Professional accountants are expected to demonstrate the highest standards of ethical behaviour and to act in the public interest. Around the world accountancy bodies have produced ethical guidance in the form of Codes of ethics in order to help professional accountants carry out their responsibilities both to their profession and to the wider public.

In Hong Kong this guidance is given in the *HKICPA's Code of Ethics for Professional Accountants* ('the *Code*') which states the following about the particular responsibilities of the professional accountant:

'A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a professional accountant's responsibility is not exclusively to satisfy the needs of an individual entity or employer.

The **public interest** is considered to be the collective well-being of the community of people and institutions the professional accountant serves, including entities, lenders, governments, employers, employees, investors, the business and financial community and others who rely on the work of professional accountants.'

Two points are very clear from this : first, the **key reason** that professional accountants must behave ethically is that **a very wide range of people rely on them and their expertise**. The second is that the accountant has a duty to serve not only the entity who has engaged his services or his employer, but the wider public interest – that is, he must be, and must be seen to be, independent.

Professional accountants hold positions of trust by the entities whom they serve, and the users of the information they provide through statutory reporting. They have access to sensitive financial and strategic information which may have a significant impact on the future direction of the business and its stakeholders.

Undertaking these professional obligations may give rise to ethical dilemmas and conflicts of interest; when it does the professional accountant may turn to the guidance laid down by the accountancy bodies, such as the Hong Kong Institute of Certified Public Accountants. As it is

impossible to anticipate the very many scenarios which may give rise to these difficulties the guidance is given in the form of fundamental principles, guidance and explanatory notes. The professional accountant is given the freedom to use his own judgment as to how to apply the principles or may seek advice from the HKICPA.

## 1.2 The fundamental principles

### HKICPA Code of Ethics

**Integrity.** A professional accountant should be **honest** and **straightforward** in all professional and business relationships. Integrity also implies **fair dealing and truthfulness**. Professional accountants should not be associated with information that contains a materially false and misleading statement or the information has been furnished recklessly.

**Objectivity.** A professional accountant should not be **biased** nor have **conflicts of interest** or **undue influence** to override professional or business judgment. The professional accountant **should not compromise** professional or business judgment due to bias. In addition, they should avoid being exposed to situations that may impair objectivity.

**Professional competence and due care.** A professional accountant should be competent to perform professional services and should **act diligently** and in accordance with applicable technical and professional standards when providing professional services.

Professional competence requires both attainment and maintenance of professional competence which requires continuing awareness and understanding of relevant technical professional and business development.

Diligence includes the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

The engagement team should have appropriate training and supervision and if there are any inherent limitations, the professional accountant should notify the entity or users of the financial statements.

**Confidentiality.** A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information **should not be used for personal advantage** or for any third parties.

There is a need to maintain confidentiality of information within the firm or within an employing organisation.

The duty of confidentiality continues even after the end of the relationship between the professional accountant and the entity.

Disclosure of information is allowed only when:

- Permitted by **law** and authorised by the entity or employer
- Required by **law** in the course of legal proceedings or to appropriate public authorities; and
- There is a **professional duty** or **right** to disclose, ie
  - To comply with technical standards and ethical requirements
  - To protect professional interests of the accountant in legal proceedings
  - To comply with a HKICPA practice review
  - To deal with an inquiry or investigation by HKICPA or other regulatory bodies

Additional requirements are set out in Section 410 'Unlawful Acts or Defaults by Clients of Members' and Section 411 'Unlawful Acts or Defaults by or on Behalf of a Member's Employer'.

**Professional behaviour.** A professional accountant should comply with relevant **laws and regulations** and should avoid any action that discredits the profession.

## HKICPA Code of Ethics

Professional accountants should not bring the profession into disrepute during its promotion.

Professional accountants should not exaggerate claims for their services that they offer, the qualifications they possess or experience they have gained.

Professional accountants should not make disparaging references or unsubstantiated comparisons to the work of others.

### 1.3 The conceptual framework

The conceptual framework in the *Code* requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles.

A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles. They should take into account both qualitative and quantitative factors when considering the significance of a threat.

When the threats are identified and the threats are clearly significant, a professional accountant should where appropriate, apply safeguards to eliminate the threats or reduce them to an acceptable level.

A professional accountant should decline or discontinue the service if no safeguards can be implemented.

A professional accountant shall use professional judgment in applying this conceptual framework.

### 1.4 Threats to compliance with the fundamental principles

There are five general sources of threat:

- (a) **Self-interest threats** – may occur as a result of the **financial** or other interests of a professional accountant or of an immediate or close family member (for example, having a financial interest in an entity)
- (b) **Self-review threats** – may occur when a previous judgment needs to be **reviewed** by the professional accountant responsible for that judgment (for example, auditing financial statements prepared by the firm)
- (c) **Advocacy threats** – may occur when a professional accountant **promotes** a position or opinion that subsequently objectivity may be compromised (for example, promoting shares in a listed entity when that entity is a financial statement audit entity)
- (d) **Familiarity threats** – may occur when due to a close relationship, a professional accountant becomes **too sympathetic** to the interests of others (for example, an audit team member having family member at the entity)
- (e) **Intimidation threats** – may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived (for example, threats of replacement due to disagreement)

### 1.5 Available safeguards

There are three general categories of safeguards:

- Safeguards created by the profession, legislation or regulation
- Safeguards in the work environment
- Safeguards created by the individual

Examples of safeguards created by the **profession, legislation or regulation**:

- Educational training and experience requirements for entry into the profession
- Continuing professional development requirements
- Corporate governance code
- Professional standards
- Professional or regulatory monitoring and disciplinary procedures
- External review by a legally empowered third party of the reports, returns, communication or information produced by a professional accountant

HKICPA issues ethical standards, quality control standards and auditing standards which work together to ensure independence is safeguarded and quality audits are carried out.

Examples of safeguards in the **work environment**:

- (a) Strong firm leadership to emphasise the importance of compliance with the fundamental principles and their expectation that members of the assurance team will act in the public interest
- (b) Establish policies and procedures to implement and monitor quality control of assurance engagement
- (c) Document the firm's independence policies including identification and evaluation of threats
- (d) Document the internal policies and procedures requiring compliance with the fundamental principles
- (e) Establish policies and procedures to identify interests or relationships between the firm or assurance team members, to monitor and manage the undue dependence on fee from a single entity
- (f) Rotation of senior audit staff, partners with separate reporting lines of the provision of non-assurance services to an entity
- (g) Establish policies and procedures to prohibit non-team members influence the outcome of the engagement
- (h) Update all partners and professional staff of firm's policies and procedures including giving appropriate training
- (i) Senior management should review the adequate functioning of the safeguarding system
- (j) Advise partners and professional staff to be independent
- (k) Establish disciplinary mechanism to promote compliance with the firm's policies and procedures
- (l) Involve an additional professional accountant to review the work done or otherwise advise as necessary
- (m) Consult an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant
- (n) Use different partners and engagement teams with separate reporting lines for the provision of non-assurance services to entities
- (o) Discuss ethical issues with those in charge of entity governance
- (p) Disclose to those charged with governance the nature of services provided and extent of fees charged
- (q) Involve another firm to perform or reperform part of the engagement

Example of safeguards created by **the individual**:

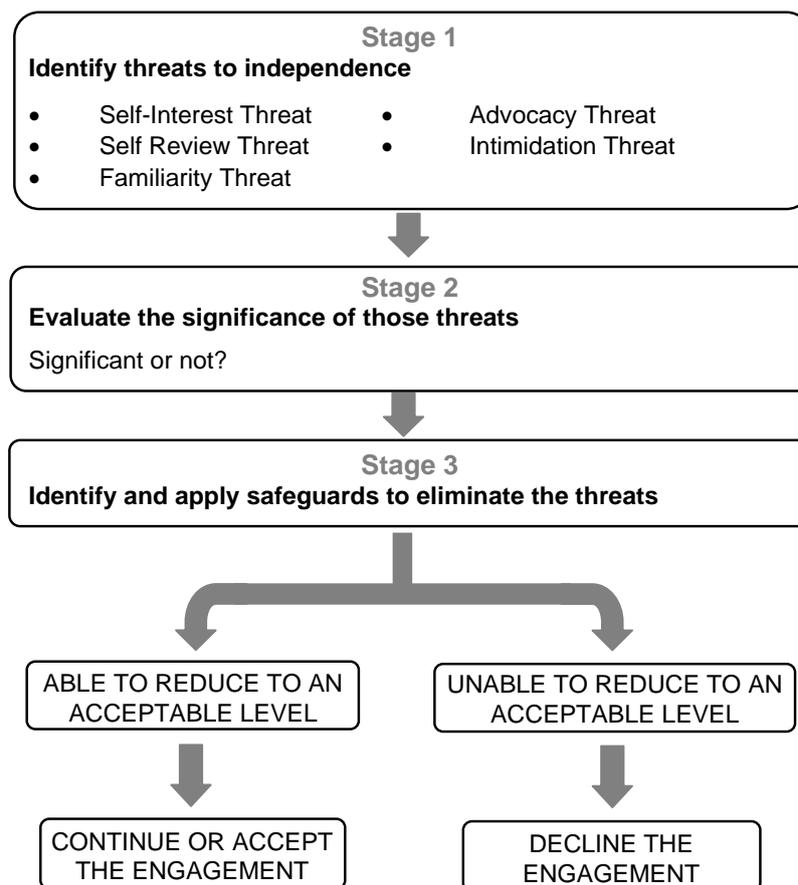
- Complying with continuing professional development requirements
- Keeping records of contentious issues and approach to decision-making
- Maintaining a broader perspective on how similar organisations function through establishing business relationships with other professionals
- Using an independent mentor
- Maintaining contact with legal advisers and professional bodies

## 2 Specific guidance: Independence

### SECTION B – Code of Ethics applicable to professional accountants in practice

Professional accountants in public practice should not engage in any activities that impair or might impair integrity, objectivity or the good reputation of the profession.

#### 2.1 Objective of the guidance



The guidance states its purpose in a series of steps. It aims to help firms and members:

### Step 1

**Identify threats** to independence.

### Step 2

**Evaluate** whether the threats are insignificant.

### Step 3

If the threats are not insignificant, **identify and apply safeguards** to eliminate risk, or reduce it to an acceptable level.

It also recognises that there may be occasions **where no safeguard is available**. In such a situation, it is only appropriate to:

- **eliminate the interest** or activities causing the threat
- **decline the engagement**, or discontinue it

## 2.2 What is independence?

A provider of assurance services must be, and be seen to be, independent. What is meant by independence?



### Key terms

**Independence of mind:** The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

**Independence in appearance:** The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.

Firms must evaluate the significance of any threats to independence and then put safeguards in place, where this is possible, to reduce the threat to acceptable levels. If it is not possible to put adequate safeguards in place, it may be better to withdraw services than to risk a conflict of interest. Certain entities, listed companies or those deemed to be of significant public interest due to the wide range of stakeholders involved, may be subject to more stringent rules.

## Section 290 INDEPENDENCE—AUDIT AND REVIEW ENGAGEMENTS

This section addresses the independence requirements for **audit engagements and review engagements**, which are assurance engagements in which a professional accountant in public practice expresses a conclusion on financial statements.

Such engagements comprise audit and review engagements to report on a complete set of financial statements and a single financial statement. Independence requirements for assurance engagements that are **not** audit or review engagements are addressed in Section 291.

### Degree of independence :

The degree of independence required is less rigid for a low level assurance engagement to non-audit clients than for audit. For example:

	Audit client	Non Audit assurance client
<b>Audit</b>	Must be independent *	N/A
<b>Non audit , general use</b>	Must be independent *	Only the assurance team and the firm must be independent.
<b>Non audit , restricted use</b>	Must be independent *	The assurance team and the firm must have no material financial interest in the client.

\* Applicable to the assurance team, the firm and the network firm



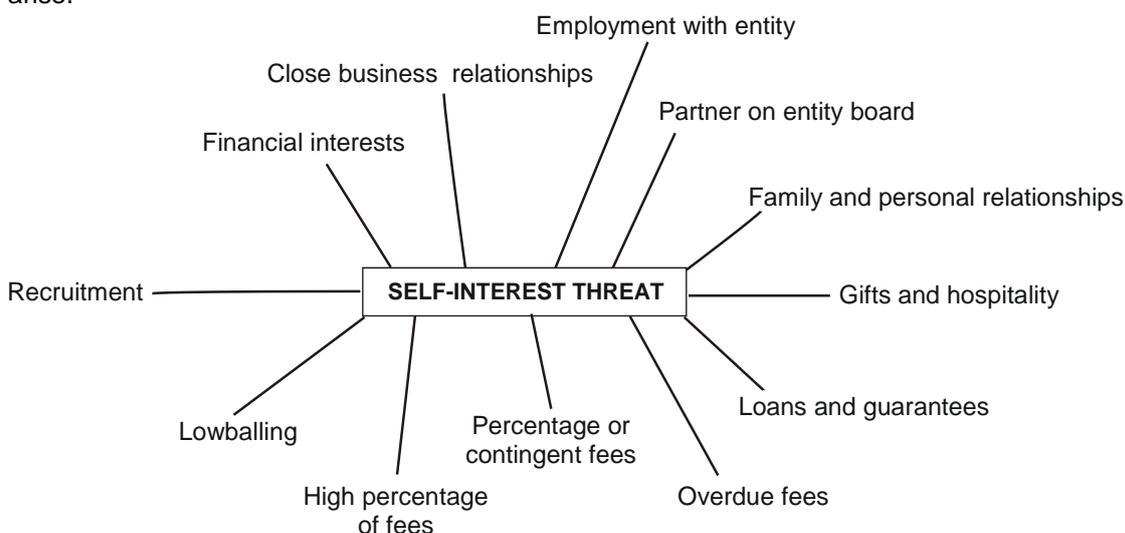
### Topic highlights

HKICPA's *Code of Ethics* gives examples of a number of situations where independence might be threatened and suggests safeguards to protect independence.

HKICPA's *Code* gives extensive lists of examples of threats to independence and applicable safeguards. In the rest of this chapter, these threats and some relevant factors and potential safeguards are outlined. Definite rules are shown in bold. You should learn these.

## 2.3 Self-interest threat

The HKICPA *Code of Ethics* highlights a great number of areas in which a self-interest threat might arise.



### 2.3.1 Financial interests

When considering whether a financial interest in a client constitutes a self interest threat, the significance of the threat should be considered in the light of the following factors:

- Nature of threat
- Degree of threat controlled by owner
- Role of the owner
- Materiality of the interest

Examples:

- Beneficial Interests in Shares/Other interest
- Overdue Fees

- Hold shares in a company's client
- Being trustee of a trusts that holds the shares in the company
- Having a retirement plan that owns shares in the company
- Material indirect ownership of shares

**Financial interest in an assurance entity may create a self-interest threat.**

The parties listed below are not allowed to own a direct financial interest or an indirect material financial interest in a client :

- The assurance firm
- A member of the assurance team
- An immediate family member of a member of the assurance team



**Key term**

A **financial interest** exists where a firm has a financial interest in an entity's affairs, for example, the firm owns shares in the entity, or is a trustee of a trust that holds shares in the entity.

A financial interest in an entity constitutes a substantial self-interest threat. According to HKICPA, **the parties listed below are not allowed to own a direct financial interest or an indirect material financial interest in an entity:**

- The firm
- A member of the assurance team
- An immediate family member (spouse or dependant) of a member of the assurance team

**Financial interest in an assurance entity may create a self-interest threat.**



**Key terms**

**Direct financial interests** are:

- financial interests owned directly by and under the control of an individual or entity
- beneficially owned through a collective investment vehicle such as trust over which the individual or entity has control

**Indirect financial interests** are:

- beneficially owned through a collective investment vehicle such as trust over which the individual or entity has no control

*Safeguards available to eliminate the threat or reduce it to an acceptable level:*

- Dispose of the direct financial interest before joining the engagement team
- Dispose of the indirect financial interest fully
- Dispose of a sufficient amount of the interest so it is no longer material before joining the engagement team
- Remove the member from the assurance engagement
- Keep the entity's audit committee informed of the situation
- Use an independent partner to review work carried out if necessary

If a member of the assurance team or their immediate family members receive the financial interest by way of inheritance, gift or through a merger, this will cause a self-interest threat.

Safeguards available to eliminate the threat or reduce it to an acceptable level:

- Dispose of the financial interest at the earliest practical date

- Remove the member from the engagement team

When a close family member has a direct financial interest or a material indirect financial interest in the entity, a self-interest threat is created.

Safeguards available to eliminate the threat or reduce it to an acceptable level are:

- (a) The close family member should dispose of all, or a sufficient amount of the financial interest, at the earliest practical date
- (b) Discuss with those charged with governance ie audit committee
- (c) Use an additional professional accountant who did not participate in the assurance engagement to review the work done
- (d) Remove the member from the engagement team

Such matters will involve judgment on the part of the partners who are charged with making decisions about ethical issues. For example, what constitutes a material interest? A small percentage stake in a company might be material to its owner. How does the firm judge the closeness of a relationship between staff and their families, in other words, what does immediate mean in this context?

Firms should have quality control procedures requiring staff to disclose relevant financial interests for themselves and close family members. They should also foster a culture of voluntary disclosure on continuous basis so that any potential problems are identified in a timely manner.

### 2.3.2 Close business relationships

There are various ways of determining whether a firm has an inappropriately close relationship with an entity and methods to address the issue if this is found to be the case. However, there is often a degree of judgment involved.

For example, **purchasing goods and services from an entity on an arm's length basis does not usually constitute a threat to independence.** However, if there are a substantial number of transactions constituting a material interest, there may be a threat to independence and safeguards may be necessary. Whether distribution or marketing arrangements under which the firm acts as distributor or marketer of the entity's products or services or *vice versa* constitute a material interest will also depend on the degree of involvement and the effect of the transactions on both businesses overall.

Where a degree of judgment is involved, **unless the interest is clearly insignificant, an assurance provider should not participate in a venture with an entity.**

If the interest may be construed as material ethical behaviour would dictate a termination of either the assurance provision or the other business relationship.

Where the significance and nature of the threat to independence involves a single individual member (or a close relation of his), appropriate ethical behaviour would demand that the individual is removed from the assurance team.

### 2.3.3 Employment with the entity

Independence may be threatened when a professional accountant is employed by both an audit firm and a client entity during the course of his career, or even where there is the prospect of employment at an entity. Where an accountant has been connected with an audit at an entity which subsequently offers employment (or may offer employment):

- Objectivity might be impaired by the motivation to impress a potential future employer
- A finance director who has a background as an audit partner has too much knowledge of the audit firm's systems and procedures to perform independently.

Again, the significance of the threat to independence depends on the specific circumstances. In considering the safeguards that may need to be put in place, consideration would be made of the

influence the individual held over the audit in the past, the time interval between the audit and the acceptance of the employment and the capacity for influence the appointment gives over the subject matter of the assurance engagement.

Good ethical practice dictates:

- (a) That a **partner should not accept a key management position at any entity with which he has been involved until at least two years have elapsed since the conclusion of the audit with which he was connected.**
- (b) **An individual who has moved from the firm to an entity should not be entitled to any benefits or payments from the firm unless these are made in accordance with pre-determined arrangements.** If money is owed to the individual, it should not be so much as to compromise the independence of the assurance engagement.
- (c) A firm should have quality control procedures requiring an individual involved in **serious employment negotiations with an entity to disclose the fact that these negotiations are taking place to the firm.** The firm may then exercise its discretion and remove the individual from the engagement.

There are further safeguards which may be used:

- (a) Modification of the assurance plan
- (b) Reassigning the engagement to another professional accountant with appropriate expertise
- (c) Involving an additional independent professional accountant to review the work performed
- (d) Carrying out a quality control review of the engagement

#### 'Cooling off' period

- A partner should not accept a key management position at any entity with which he has been involved until at least **two years** have elapsed since the conclusion of the audit with which he was connected.

The revised Code required 'cooling off periods' where partners intend to join public interest entities as follows :

- **Key audit partner** : one audit opinion covering a period of not less than 12 months for which the partner was not a member of the audit team
- **Firm's Managing Partner** (or equivalent): one year

A **new** provision is that an individual who has moved from the firm to a client should not be entitled to **any benefits or payments** from the firm unless pre-determined arrangements have been made.

### 2.3.4 Partner on entity board

**A partner or employee of the firm should not serve on the board of an entity, although** in some circumstances it is permissible for a partner or employee of an assurance firm to serve as company secretary, or in a similar purely administrative role

### 2.3.5 Family and personal relationships

Family or close personal relationships constitute a serious threat to independence. Again, the significance of the threat requires individual circumstances, such as those listed below, to be taken into account:

- The individual's responsibilities on the assurance engagement. This includes the degree of influence the individual may exert over the outcomes of the audit. However, the close family relationships with a directors, officers or employees of an entity should be monitored even if that individual is not part of the particular assurance team).
- The closeness of the relationship, (see the definition given in the *Code* of what constitutes immediate family).

- The role of the other party at the entity. This means whether they exert significant influence over the subject matter of the assurance engagement as a director, company officer or employee and how closely they are involved with the processes and so on being tested).

The *Code* defines an immediate family member as a spouse or dependant. When a close family relationship is disclosed it is usually appropriate to remove the individual from the assurance team.

A firm should have quality control procedures under which employees should disclose if a close family member employed by a client is promoted within the entity so increasing the risk of a significant threat.

If a firm inadvertently violates the rules concerning family and personal relationships there are further safeguards available: in these circumstances it is usual to conduct a quality control review or discuss the matter with the entity's audit committee if it is of sufficient size to have one.

### 2.3.6 Gifts and hospitality

This is a notoriously difficult area; in some parts of the world, offering gifts or corporate hospitality is an accepted part of business life; in others, it falls into a grey area somewhere between inducement and downright bribery! In general, unless the value of the gift or hospitality is **clearly insignificant** a member of an assurance team should decline any offers which may be seen to be intended to influence the judgment of a professional accountant..

### 2.3.7 Loans and guarantees

The advice on loans and guarantees is similar to that on business transactions. If the loan from a financial institution, is made on an arm's length usual commercial basis, then there is no threat to independence. For individuals, a loan of this sort is likely to be material, such as a mortgage, but as long as usual commercial terms apply, there is no impairment to independence.

If a loan to a firm is deemed material it is necessary to apply safeguards to reduce the risk to an acceptable level. One safeguard likely to be used is an independent review (by a partner from another office in the firm).

**However, the firm or an individual on the assurance engagement should never enter into any loan or guarantee arrangement with an entity that is not a bank or similar institution.**

The advice on loans and guarantees falls into two categories :

- client is a bank or similar institution
- other situations

### 2.3.8 Overdue fees

By allowing fees to remain overdue, the professional accountant runs the risk of effectively offering a loan to an entity. The professional accountant may then run the risk of being in breach of the rules set out above.

Appropriate safeguards include an independent review to ensure that the fees charged are fair for the work performed. Policies should be in place to ensure that unpaid fees do not build up to unfeasibly high levels. Unpaid fees should be discussed with the entity's senior management promptly. If the fees remain unpaid then the firm should consider resignation.

### 2.3.9 Percentage or contingent fees



#### Key term

**Contingent fees** are fees which are calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.

**A firm should not enter into a contingent fee arrangement for any assurance engagement as payment arrangements based on outcomes create self-interest and advocacy threats which cannot be reduced to acceptable levels through the application of suitable safeguards.**

There are some circumstances where it may be appropriate to accept a contingent fee for non-assurance work if suitable safeguards are in place. Suitable safeguards include:

- making disclosures to the audit committee about the fees
- review or determination of the fee by an unrelated third party
- quality control policies and procedures

Whether a contingent fee is acceptable depends on factors such as the following::

- the range of possible fee outcomes
- the degree of variability in the fee
- the basis on which the fee is to be determined
- whether the transaction is to be reviewed by an independent third party
- the effect of the transaction on the assurance engagement

In rare cases, it may be appropriate to accept a contingent fee for non assurance work if suitable safeguards are in place ie disclosing to audit committees, reviewing fee by an unrelated third party and implementing quality control policies and procedures.

#### **Contingent fees charged on non-assurance engagement**

A contingent fee **charged directly or indirectly by a firm** in respect of a non-assurance service provided to an audit client may also create a **self-interest threat**. The threat created would be so significant that **no safeguards** could reduce the threat to an acceptable level if:

- The fee is charged by the **firm expressing the opinion** on the financial statements and the fee is material or expected to be material to that firm;
- The fee is **charged by a network firm** that participates in a significant part of the audit and the fee is material or expected to be material to that firm; or
- The outcome of the non-assurance service, and therefore the amount of the fee, is dependent on a future or contemporary judgment related to the audit of a material amount in the financial statements.

**All arrangements shall be prohibited.**

### **2.3.10 Undue dependence on total fees**

A self-interest threat arises where the total fees generated by an entity represent a large proportion of a firm's total revenue.

**The public may perceive that a firm's objectivity is likely to be in jeopardy where the fees for audit and recurring work paid by an entity or group of connected entities exceeds 15 per cent of the firm's total fees. If the entity is listed or is otherwise deemed to be of public interest, this figure is lowered to 10 per cent.**

Whether it is a situation of undue dependence may be mitigated by factors such as the size and structure of the firm and how long it has been trading (a new firm may not have a wide enough client base to follow the ruling emboldened above).

Similar threats may be created by situations where the fees generated by an entity represent a large proportion of the revenue brought in by an individual partner.

Safeguards in these situations include:

- discussion of the matter with the entity's senior management or the audit committee if it has one
- taking steps to reduce the financial dependency on the entity
- obtaining external or internal quality control reviews
- consulting a third party such as HKICPA

### Audit Clients that are Public Interest Entities (new provision)

Where an audit client is a **public interest entity** and, for **two consecutive years**, the total fees from the client and its related entities represent **more than 15% of the total fees** received by the firm expressing the opinion on the financial statements of the client, the firm shall disclose to those charged with governance of the audit client the fact that the total of such fees represents more than **15% of the total fees** received by the firm, and discuss which of the safeguards below it will apply to reduce the threat to an acceptable level, and apply the selected safeguard:

- **A pre-issuance review** - Prior to the issuance of the audit opinion on the second year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, **performs an engagement quality control review** of that engagement or a professional regulatory body performs a review of that engagement that is equivalent to an engagement quality control review.
- **A post-issuance review** - After the audit opinion on the second year's financial statements has been issued, and before the issuance of the audit opinion on the third year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, or a professional regulatory body performs a review of the second year's audit that is equivalent to an engagement quality control review .

#### 2.3.11 Lowballing

Lowballing is the term used to describe the situation where a firm quotes a significantly lower fee level for an assurance service than would have been charged by the predecessor firm usually in order to gain other more lucrative business. A self-interest threat arises which must be safeguarded against. If the firm wins the tender the following safeguards should be applied:

- careful record keeping to demonstrate that the firm used appropriate staff, spent sufficient time, and adhered to appropriate technical and professional standards in carrying out the engagement;
- demonstration that the assurance engagement complied with all applicable assurance standards, guidelines and quality control procedures

In other words, the low generation of fee revenue must not have any adverse impact on the quality of the review carried out. Lowballing and the significant low fee issue below carry the risks of fee disputes, if the company is eventually forced to make a choice between losing money or compromising on quality or if the lucrative other business the firm hoped to win on the back of the loss-making audit does not materialise.

#### 2.3.12 Significant low fee

A firm is entitled to charge a significant low fee for any reason but should be aware of the threat to objectivity this creates. This fee strategy may cause a self-interest threat and call into question the professional competence and due care owed by the firm. Both independence and quality of work may be compromised as it may be difficult to perform the engagement in accordance with applicable technical and professional standards for the fee charged.

The professional accountant should consider if there is:

- any terms on securing the contract to supply other non-audit services (lowballing issue)
- any compromise on the quality of the audit work
- any restriction on senior staff working on the audit
- any possibility the entity was misled as to the basis on which fees for the current and subsequent years were to be determined
- awareness by the entity of all the terms of the engagement and fees charged
- appropriate review to ensure work is done fully in accordance with auditing standards; and should
- appropriate time and competent staff assigned to the engagement.

By engaging in these risky pricing strategies the firm not only threatens its independence but also raises the risk of fee disputes and negligence claims that could do long-term damage to the business.



### Self-test question 1

FF Limited has decided to put their audit out to tender and has asked your firm S&S Partners and one other firm to participate in the tendering process. You become aware that the other firm has submitted a tender with a fee 50 per cent less than your preliminary fee estimate. Your tender has not yet been submitted. You are concerned that if you submit your tender as it stands, there will be no chance of winning the audit.

*Required*

- (a) Discuss the ethical issues involved in relation to the other firm's fee estimate.
- (b) What action would you take as a result of the above?

**(The answer is at the end of the chapter)**

### 2.3.13 Recruitment

Professional accountants may offer HR consultancy services (see the further discussion of this in 2.4 below). However, recruitment and assurance services offered by the same firm may result in a conflict of interest and either the assurance business or the consultancy business should be declined. It may be acceptable for the assurance firm to play a limited part in say, the recruitment of a senior officer at an entity who uses their assurance services, if the final decision for the appointment rests with another party.

### 2.3.14 Actual or threatened litigations

A firm's objectivity may be threatened, or appear to be threatened, when the firm is involved in litigation with an entity. Litigation represents a **breakdown of the relationship of trust**. Directors of the entity will be reluctant to disclose information to the professional accountants who may rely on it during proceedings.

If the threatened litigation is to sue the professional accountant for negligence, the firm must resign.

There are **no appropriate safeguards** to reduce the threat to an acceptable level; the only appropriate action is to withdraw from the engagement and:

- (a) disclose the extent and nature of the litigation to the audit committee or those charged with governance
- (b) if there is a member of the assurance team involved in the litigation, he should be removed from the engagement team
- (c) engage an additional professional accountant to review work done

If it relates to unpaid fees, professional accountants do not necessarily have to resign.

#### Compensation and Evaluation Policies

A **self-interest threat** is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to that audit client.

The significance of the threat shall be evaluated and, if the threat is not at an acceptable level, the firm shall either revise the compensation plan or evaluation process for that individual or apply safeguards to eliminate the threat or reduce it to an acceptable level.

A **key audit partner** shall not be evaluated on or compensated based on that partner's success in selling non-assurance services to the partner's audit client. This is not intended to prohibit normal profit-sharing arrangements between partners of a firm.

### 2.3.15 Receiving or paying referral and commission

Paying a commission or referral fee or accepting this kind of fee is acceptable. However, accepting a referral fee may create **self-interest threat** to objectivity and call into question professional competence and due care. Safeguards should be applied:

- (a) Disclose to the entity the arrangement to pay/receive a referral fee to another professional accountant for the work passed onto them
- (b) Obtain advance agreement from the entity for commission arrangements in connection with the sale by a third party of goods or services to the entity

## 2.4 Self-review threat



Self-review threats arise when a professional accountant, or a firm of professional accountants, have previously been involved in performing a service which they are then called upon to review. This may include setting up financial systems they are then asked to review, or preparing financial records or valuations for the financial statements they are then asked to audit. The risk is greater when the service was performed very recently. As market competition has encouraged firms of professional accountants to expand the range of services they may offer entities, so the risk of self-review has increased. The table below shows a range of the services that may be provided and there follows a discussion about how the provision of these services may impair independence.

#### Services provided by professional accountants

Bookkeeping

Preparation of financial statements

Tax services, although generally these are not seen to impair independence

Design and implementation of financial information systems

Appraisal, valuation services and fairness opinions

Actuarial services

Internal audit services

Management functions, but there are strict rules (see bold text) about the degree to which assurance advisers may intervene in the management decisions of the entity

Human resources – such as recruitment and selection of senior management , provision of temporary staff cover and so on

Corporate finance, broker-dealer services, accessing finance and so on

Legal services and litigation support

Risk of self review

The HKICPA *Code* gives rules about the other services firms may provide to their entities, (see below).

The distinction between listed companies, (or public interest companies), and private companies is an important one in the provision of other services to entities. The rules are much more stringent for listed companies and those deemed to be of public interest.



### Key terms

**Listed companies** are those whose shares have been admitted to a recognised exchange, such as the Stock Exchange of Hong Kong.

**Public interest companies** are those which for some reason (size, nature, product) are in the 'public eye'. Professional accountants should treat these as if they are listed companies.

## 2.4.1 Recent service

The *Code* sets out the following rule with regard to **individuals who have completed a recent period of service** with an entity:

**Individuals who have held the role of director or served as an officer of the entity, or been an employee in a position to exert direct, significant influence over the subject matter of the assurance engagement in the period under review or the previous two years should not be assigned to the assurance team.**

If an individual had been closely involved with the entity but outside of the time limits established above, the assurance firm should consider the threat to independence and apply safeguards, if appropriate. This may be to

- obtain a quality control review of the individual's work on the assignment
- discuss the issue with the audit committee if the entity has one

## 2.4.2 General other services

Another rule which should be learned is that, where the assurance firm is providing other services for an entity:

**For entities, professional accountants are not allowed to:**

- **authorise, execute or consummate a transaction**
- **sanction a particular course of action for the entity to pursue (this is a matter for its own management)**
- **report in a management capacity to those charged with governance**

However, keeping custody of an entity's assets, supervising the entity's employees in the performance of their normal duties, and preparing source documents on an entity's behalf are a common requirement for assurance firms which could also pose significant self-review threat, Safeguards which may be used to address this are:

- (a) Segregation of duties: the assurance firm can make sure that different staff are used on the assurance team to the staff engaged in the other capacity
- (b) Seeking the advice of an independent professional accountant
- (c) Clear quality control policies establishing what staff are and are not allowed to do on behalf of entities
- (d) Making appropriate disclosures and discussion of the matter with those charged with governance

- (e) Resigning from the assurance engagement
- (f) Establishing policies and procedures to prohibit professional accountants from making managerial decisions on behalf of the entity

### 2.4.3 Preparing accounting records and financial statements

Management is responsible for the **preparation and fair presentation** of the financial statements in accordance with the applicable financial reporting framework.

Professional accountants routinely assist management with the preparation of financial statements and give advice about accounting treatments and journal entries. A self-review threat arises if the same firm is then asked to audit the accounting records that they have prepared.

If the firm is listed or public interest, it **should not prepare accounts or financial statements for a listed or public interest entity**, unless an emergency arises.

The rules are more relaxed for small entities where a single firm is likely to be involved with the business in a number of capacities. In these situations, firms must analyse the risks arising and put safeguards in place to reduce the risk to an acceptable level. Safeguards include:

- using staff members other than assurance team members to carry out work
- obtaining entity approval for work and underlying assumptions undertaken

#### **New Concepts :**

##### **Audit clients that are not public interest entities**

The firm may provide services related to the preparation of accounting records and financial statements to an audit client that is **not a public interest entity** where the services are of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level.

For any client, assurance firms are also **not allowed** to:

- determine or change journal entries without client approval
- authorise or approve transactions
- prepare source documents

##### **Audit clients that are public interest entities**

Except in **emergency situations**, a firm shall not provide to an audit client that is a public interest entity accounting and bookkeeping services, including payroll services, or prepare financial statements on which the firm will express an opinion or financial information which forms the basis of the financial statements.

##### **'Emergency situations'**

Accounting and bookkeeping services may be provided to audit clients in emergency or other unusual situations when it is impractical for the audit client to make other arrangements .

- **only the firm has the resources and necessary knowledge** of the client's systems and procedures to assist the client in the timely preparation of its accounting records and financial statements
- restriction on the firm's ability to provide the services would result in significant difficulties for the client to comply regulatory requirements

##### **Conditions before performing :**

- those who provide the services are not members of the audit team;
- the services are provided for only a short period of time and are not expected to recur; and
- the situation is discussed with those charged with governance.

However, for any entity, firms are never allowed to:

- (a) determine or change journal entries without entity's approval
- (b) authorise or approve transactions

- (c) prepare original source documents
- (d) report on behalf of management to those charged with governance
- (e) supervise an entity's employee in performing normal activities

#### 2.4.4 Temporary staff assignments

The lending of staff by a firm to an audit client may create a **self-review threat**. Such assistance may be given, but only for a short period of time and the firm's personnel shall not be involved in:

- Providing non-assurance services that would not be permitted under this section; or
- Assuming management responsibilities.

In all situations, the audit client shall be **responsible for directing and supervising** the activities of the loaned staff.

#### 2.4.5 Valuation services



##### Key term

A **valuation** comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

If a firm performs a valuation to be included in the entity's financial statements which are then subsequently audited by the firm, a self-review threat arises.

**A firm should not carry out valuations on matters:**

- (a) **which are material to the financial statements and**
- (b) if the valuation is subject to high degree of subjectivity.

No safeguard is available to reduce the threat to an acceptable level under these circumstances.

If the valuation is neither material nor subject to high degree of subjectivity, the firm may apply safeguards to ensure that the risk is reduced to an acceptable level. The following matters need to be considered:

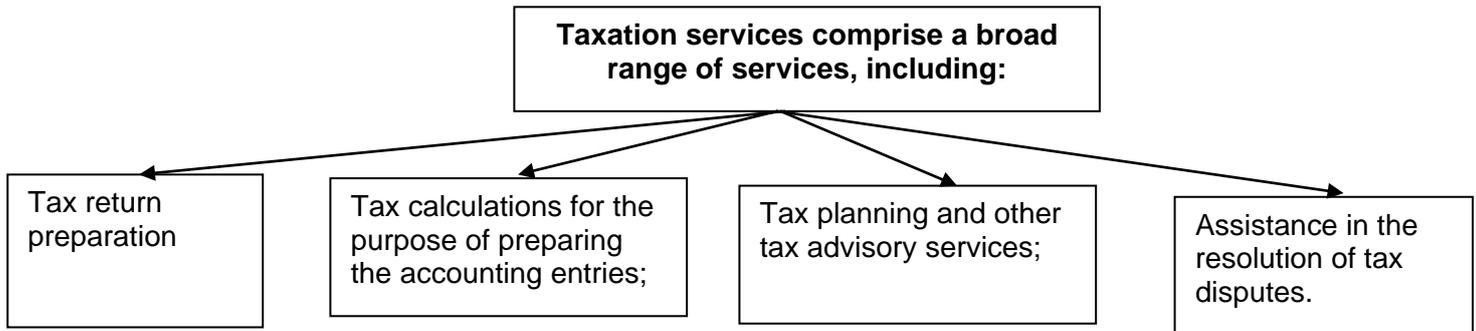
- The extent of the entity's knowledge of the relevant matters in making the valuation
- The degree of judgment involved,
- How much use is made of established methodologies
- The degree of uncertainty in the valuation.

The firm may use the following safeguards to manage the risk:

- Second partner review
- Confirming that the entity understands how the valuation is reached and the underlying assumptions
- Ensuring the entity acknowledges its responsibility for the valuation
- Using separate staff for the valuation and the audit

#### 2.4.6 Taxation services

Generally, the provision of taxation services is not seen as any threat to independence.



Performing certain tax services creates **self-review and advocacy threats**.

The existence and significance of any threats will depend on:

- the system by which the tax authorities assess and administer the tax in question and the role of the firm in that process,
- the complexity of the relevant tax regime and the degree of judgment necessary for application
- the particular characteristics of the engagement
- the level of tax expertise of the client's employees.

#### **Tax return preparation**

Accordingly, providing such services **does not** generally create a threat to independence if management takes responsibility for the returns including any significant judgments made.

#### **Tax calculations for the purpose of preparing accounting entries**

##### **(i) audit clients that are not public interest entities -**

Preparing calculations of current and deferred tax liabilities (or assets) for an audit client for the purpose of preparing accounting entries that will be subsequently audited by the firm creates a self-review threat.

Safeguards shall be applied when necessary to eliminate the threat or reduce it to an acceptable level.

##### **(ii) audit clients that are public interest entities -**

Except in emergency situations, in the case of an audit client that is a public interest entity, a firm shall not prepare tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements on which the firm will express an opinion.

#### **Tax planning and other tax advisory services**

Such services involve advising the client how to structure its affairs in a tax efficient manner or advising on the application of a new tax law or regulation.

A self-review threat may be created where the advice will affect matters to be reflected in the financial statements.

The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

#### **Safeguards:**

- using professionals who are not members of the audit team to perform the service
- having a tax professional, who was not involved in providing the tax service, advise the audit team on the service and review the financial statement treatment
- obtaining advice on the service from an external tax professional; or
- obtaining pre-clearance or advice from the tax authorities.

Where the **effectiveness of the tax advice** depends on a particular accounting treatment or presentation in the financial statements and the self-review threat would be so significant that **no safeguards** could reduce the threat to an acceptable level. Accordingly, a firm shall not provide such tax advice to an audit client.

### Assistance in the resolution of tax disputes

An advocacy or self-review threat may be created when the firm represents an audit client in the resolution of a tax dispute once the tax authorities have notified the client that they have rejected the client's arguments on a particular issue and either the tax authority or the client is referring the matter for determination in a formal proceeding,

Where the taxation services involve acting as an advocate for an audit client before a public tribunal or court in the resolution of a tax matter and the amounts involved are material to the financial statements on which the firm will express an opinion, the advocacy threat created would be so significant that no safeguards could eliminate or reduce the threat to an acceptable level.

## 2.4.7 Internal audit services

Internal audit activities may include:

- monitoring of internal control
- examination of financial and operating information
- review of the economy, efficiency and effectiveness of operating activities
- review of compliance with laws, regulations and other external requirements, and with management policies and directives

The **provision of internal audit services** to an audit client creates a self-review threat to independence if the firm uses the internal audit work in the course of a subsequent external audit.

Performing a significant part of the client's internal audit activities increases the possibility that firm personnel providing internal audit services will assume a management responsibility.

A firm may provide internal audit services to an entity, without impairment to independence so long as the firm ensures that the entity recognises its responsibility for establishing, maintaining and monitoring the internal controls. Usually the following safeguards are put in place:

- (a) an employee of the entity is made responsible for all internal audit activities
- (b) the entity approves all of the work undertaken by the internal audit team.

### Audit clients that are public interest entities

In the case of an audit client that is a public interest entity, a firm **shall not provide internal audit services** that relate to:

- a significant part of the internal controls over financial reporting
- financial accounting systems that generate information that is, separately or in the aggregate, significant to the client's accounting records or financial statements on which the firm will express an opinion; or
- amounts or disclosures that are, separately or in the aggregate, material to the financial statements on which the firm will express an opinion.

## 2.4.8 Corporate finance

Certain aspects of corporate finance create self-review threats that cannot be reduced to an acceptable level by safeguards. A **firm is not allowed to promote, deal in or underwrite an entity's shares under any circumstances**. Similarly, **it is also not allowed for a firm to commit an entity to the terms of a transaction or consummate a transaction**. There are other corporate finance services, formulating corporate strategies, raising capital or providing

restructuring advice which may be acceptable without impairment to independence, providing that appropriate safeguards are in place. Such safeguards include using different teams of staff, and making sure policies in place to ensure that no management decisions are taken on behalf of the entity are closely controlled.

### **The Hong Kong Takeovers and Share Repurchase Codes**

A member who provides takeover services for clients is required to comply with the Codes which are expressly applied to professional advisers as well as to those engaged in the securities market.

### **The Stock Exchange of Hong Kong Limited's (Stock Exchange) Rules Governing the Listing of Securities (Listing Rules)**

Members' attention is also drawn to the Listing Rules in particular when acting as a sponsor or as an independent financial adviser.

## **2.4.9 Other services**

There are other services a firm might offer to entities:

### **IT services**

Providing systems services may create a **self-review threat** depending on the nature of the services and the IT systems.

Providing services to an audit client that is **not a public interest entity** involving the design or implementation of IT systems that:

- (a) form a significant part of the internal control over financial reporting or
- (b) generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion creates a self-review threat.

In the case of an audit client that is a **public interest entity**, a firm shall not provide services involving the design or implementation of IT systems that:

- (a) form a significant part of the internal control over financial reporting or
- (b) generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion.

### **Temporary staff cover**

Providing recruiting services to an audit client may create **self-interest, familiarity or intimidation threats**.

The firm may generally provide such services as reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the post.

A firm **shall not** provide recruiting services to an audit client that is a public interest entity with respect to a director or officer of the entity or senior management in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm relies.

### **Litigation support services**

Providing legal services to an entity that is an audit client may create both self-review and advocacy threats.

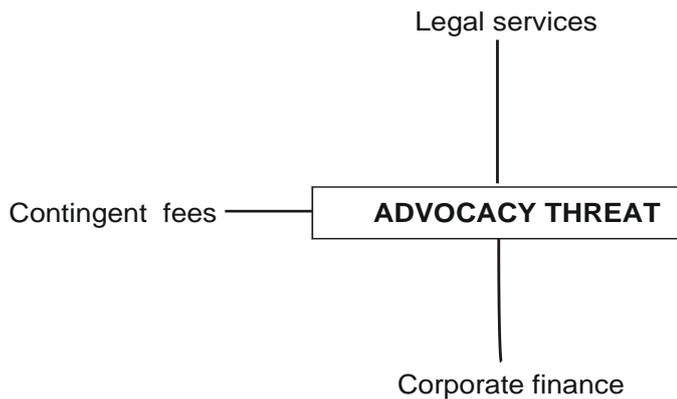
Acting in an advocacy role for an audit client in resolving a dispute or litigation when the amounts involved are material to the financial statements on which the firm will express an opinion would create advocacy and self-review threats so significant that no safeguards could reduce the threat to an acceptable level.

The appointment of a partner or an employee of the firm as General Counsel for legal affairs of an audit client would create self-review and advocacy threats that are so significant that no safeguards could reduce the threats to an acceptable level.

## Legal services

In each case, the firm should consider whether there are any barriers to independence and whether these can be reduced by appropriate safeguards. Among the scenarios which might fall into this category are where a firm is asked to design internal control IT systems, which it would later review as part of its audit, or a professional accountant from the firm was seconded to cover the finance director's maternity leave. Before you read on, what would you consider to be appropriate ethical behaviour in those two circumstances.

## 2.5 Advocacy threat

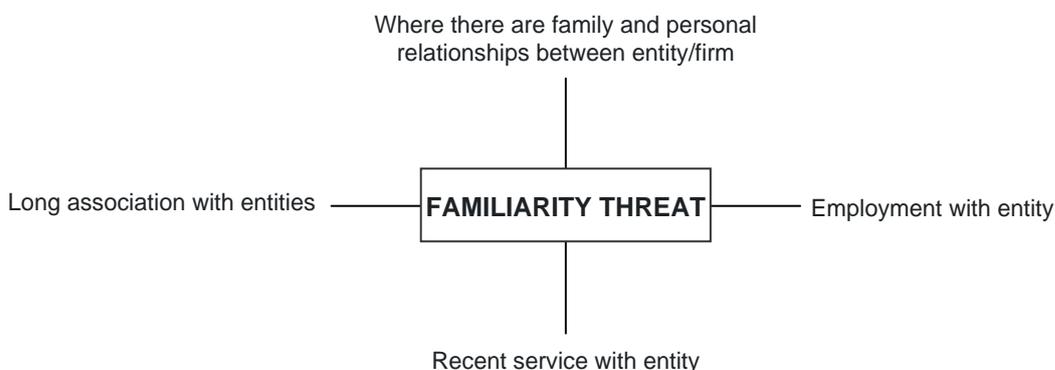


An advocacy threat often arise in the provision of legal or corporate finance services. To avoid this threat firms must avoid being in the position of taking the entity's part in a dispute or somehow acting as their advocate in a way that threatens the appearance of independence. Examples are when a firm has provided legal services to an entity and, perhaps defended them in a legal case. Corporate finance examples are where the firm gives such as advice on debt reconstruction and negotiates with the bank on the entity's behalf or deals or acts as a promoter of shares for an entity. In these instances a professional account **promote or may be seen to promote** an entity's position to the point that objectivity may be impaired.

Again, the firm may be able to reduce the threat by using appropriate safeguards, including separate teams and disclosures, but if the threat cannot be reduced to an acceptable level the firm must withdraw from the engagement.

## 2.6 Familiarity threat

A familiarity threat often arises in conjunction with a self-interest threat. Independence is jeopardised by the firm and its staff becoming too closely connected or too familiar with or sympathetic to the entity and its employees. Professional skepticism may be severely impaired in circumstances.



## 2.6.1 Long association of senior personnel with entities

A long association with an entity may erode the independence of senior members of staff as the length of service may mean they become too close to or too overly sympathetic to the business to remain objective and exercise professional skepticism. Firms should continually monitor the relationship between staff and established entities, including requirements to disclose any promotions or changes within the entities which may introduce a new risk. Control can be established by the use of safeguards such as rotation of senior personnel, second partner reviews, and internal independent quality control reviews.

In addition, the *Code of Ethics* goes further for listed and public interest entities with a list of specific rules to prevent this situation from arising. It is in your interest to learn them!

The rules state that **for the audit of listed or other public interest entities:**

- The engagement partner should **be rotated after a pre-defined period**
- Other key audit partners should be rotated after a pre-defined period, **normally no more than seven years, and should not return to the engagement until a period of two years has elapsed**
- **The individual responsible for the engagement quality control review should be rotated after a pre-defined period**

**If an entity becomes a listed entity, the engagement partner, other key partners and quality control personnel should only continue in those positions for another two years.** Judgment may need to be exercised for more junior staff based on the length of time they have been involved with the audit.

Flexibility is required for smaller firms where size constraint may mean rotation is practicable or reliance on a key person's expertise would mean the risk to technical quality is greater than that derived from the previous connection. In this case, the firm must devise suitable safeguards to make sure independence is preserved.

### (a) Listed Companies and other public interest entities :

The rules state that **for the audit of listed or other public interest entities:**

- The engagement partner should **be rotated after a pre-defined period**
- Other key audit partners should be rotated after a pre-defined period, **normally no more than seven years, and should not return to the engagement until a period of two years (or five years if returning as engagement partner) has elapsed**
- The individual responsible for the engagement quality control review should be rotated after a pre-defined period, **normally no more than seven years, and should not return to the engagement until a period of two years has elapsed.**

If an entity becomes a listed entity, the engagement partner, other key partners and quality control personnel should only continue in those positions for **another two years**. Judgment may need to be exercised for more junior staff based on the length of time they have been involved with the audit.

### (b) Rotation of Key audit partners

**Familiarity and self-interest threats** are created by using the same senior personnel on an audit engagement over a long period of time.

Despite the above, key audit partners whose continuity is especially important to audit quality may, in rare cases due to unforeseen circumstances outside the firm's control, be permitted **an additional year** on the audit team as long as the threat to independence can be eliminated or reduced to an acceptable level by applying safeguards.

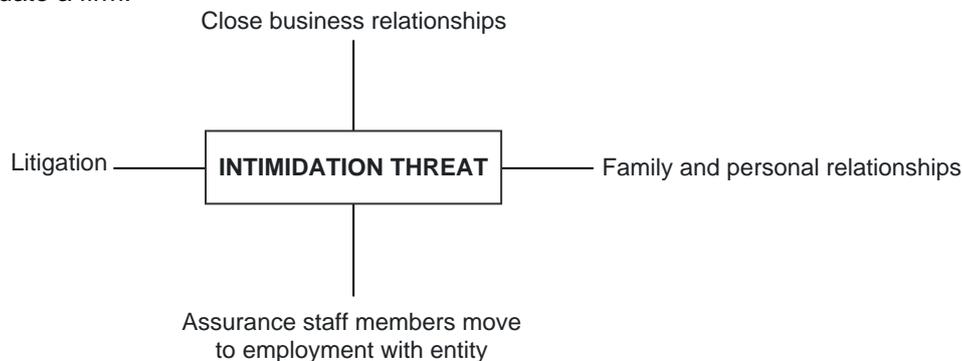
**When an audit client becomes a public interest entity**, the length of time the individual has served the audit client as a key audit partner before the client becomes a public interest entity shall be taken into account in determining the timing of the rotation.

If the individual **has served the audit client as a key audit partner for five years or less** when the client becomes a public interest entity, the number of years the individual may continue to serve the client in that capacity before rotating off the engagement is seven years less the number of years already served.

When a firm has **only a few people** with the necessary knowledge and experience to serve as a key audit partner on the audit of a public interest entity, rotation of key audit partners may not be an available safeguard.

## 2.7 Intimidation threat

An intimidation threat arises when members of the assurance team are intimidated or pressured to act unethically by entity staff. This generally means the firm has something to lose or is under pressure in some way which the entity is trying to push to its own advantage. Loss of business, replacement with another auditor and litigation are some of the methods by which an entity may try to intimidate a firm.



A professional accountant may be dissuaded from using objectivity and exercising professional skepticism by threats, whether actual or perceived from directors of an entity.

There are three main types of threat:

*Loss of business*; for instance, as a result of a disagreement over the application of an accounting principle, the entity may threaten to change its auditors if they wish to modify their report as a result of the dispute

*Loss of fee revenue*; for instance, the entity may apply pressure to reduce the extent of work performed by the professional accountants unjustifiably in order to reduce the fees

*Litigation*: defending a claim for negligence can be time consuming, publicly damaging and expensive, even if the assurance firm were to eventually win the case (see below).

### 2.7.1 Actual and threatened litigation

Litigation, threatened or real, is a very serious threat indeed for firms: not only does it involve the loss of the immediate client, the firm may suffer further losses from the associated negative publicity and association with negligent behaviour, even if successfully defended. The threat may lead to the firm being put under pressure to publish an unqualified audit report although they have been qualified in the past, for example. The risk is so great that if the litigation is at all serious, the firm should consider resignation.

However, good control systems should be in place to prevent such situations arising. When they do, the following considerations should be taken into account:

- The materiality of the litigation
- The nature of the assurance engagement
- Whether the litigation relates to a prior assurance engagement

The following safeguards could be applied:

- Disclosing to the audit committee the nature and extent of the litigation
- Removing specific affected individuals from the engagement team
- Involving an additional professional accountant on the team to review work

### 2.7.2 Second opinions

An entity may seek a **second opinion** from a different firm when they are unhappy with the audit opinion given or the work performed. The second firm, as it is not officially appointed, is notable to give a formal audit opinion on the financial statements. However, if a another firm indicates to an entity's management that a different audit opinion might be acceptable, the appointed firm may feel under pressure to change the audit opinion in order to preserve the client relationship. In effect, a self-interest threat arises.

In practice, second opinions often cause independence issues for firms of professional accountants and care should be taken if asked to provide one.

A company director is free to talk to a another firm about the treatment of matters in the financial statements if he believes there is a good reason for doing so. However, new accounting standards are increasingly prescribing a single method of treatment reducing the scope for subjectivity and the need for this kind of second opinion. Where an opinion like this is sought, the second firm is relying on the director to communicate all of the relevant information on which the original opinion has been based in a factual manner ie without any bias which may lead the professional accountants to take a view that the entity might prefer. It is usual for the second firm to request the co-operation of the appointed firm in order to ensure they have all the information they need. If this is refused, there are probably good reasons why the engagement should be declined.

Safeguards are:

- obtain the entity's consent
- describe the limitations surrounding any opinion in communications with the entity
- provide the existing professional accountant with a copy of the opinion

## Section 291 INDEPENDENCE – OTHER ASSURANCE ENGAGEMENTS

This section addresses independence requirements for assurance engagements that are not audit or review engagements.

### 2.7.3 Multiple Responsible Parties

In some assurance engagements, whether **assertion-based or direct reporting**, there might be several responsible parties. In determining whether it is necessary to apply the provisions in this section to each responsible party in such engagements, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is not trivial and inconsequential in the context of the subject matter information.

### 2.7.4 Interpretation 2005-01 (Revised June 2010 to conform to changes resulting from the IESBA's project to improve the clarity of the Code)

This interpretation focuses on the application issues that are particular to assurance engagements that are not financial statement audit engagements.

**Assertion-Based Assurance Engagements**

In an **assertion-based assurance engagement** independence is required from the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter.

**Direct Reporting Assurance Engagements**

In a **direct reporting assurance engagement**, the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users.

**Self-test question 2**

- (a) Mr Chan is a partner of a large international firm.. One of the entities is ABC Limited (ABC), a large multinational corporation. Recently, Mr Chan was happy that his daughter was engaged to Mr Yeung who is the financial controller of ABC. Mr Chan is concerned about the independence issue and is considering withdrawal from the engagement team for the current year. The interim work has been completed with no major problems.

*Required*

Discuss whether Mr Chan is obliged to withdraw from the engagement team in the current financial year.

- (b) Assume Mr Chan has withdrawn from the engagement team. One of the audit managers, Alan, responsible for auditing ABC, has discovered that the management of ABC might not have complied with certain laws. After discussion and review of labour costs expenses, Alan suspects that ABC might have employed illegal workers in order to reduce labour costs. ABC's operational staff has confirmed to Alan that this is the practice adopted.

Alan also suspects that ABC might have bribed the staff of its customers as some unexplained payments appear in ABC's records. Alan's university classmate, Dave, who works in the Independent Commission Against Corruption (ICAC), calls Alan to request information about ABC.

*Required*

Should Alan disclose the possible offences of ABC to Dave?

- (c) Recently, Alan has also been appointed as the manager-in-charge of the engagement for the flotation on the GEM of a high technology company, BT Company. The firm would be responsible for reporting on the trading results of BT. The partner told Alan that the firm's engagement is for listing work. Its success would help to promote the firm to existing and new entities who are considering listing. The firm would provide audit, tax and company secretarial work for BT. Any non-appointment would cause a loss of approximately 10 per cent of the firm's annual revenue.

*Required*

Should the firm accept the BT engagement?

**(The answer is at the end of the chapter)**

## 2.8 HKSQC 1: Quality control: Independence

HKSQC 1 is the quality control standard issued by HKICPA and within it, there is a particular requirement which refers to ethics.

**Firm should establish policies and procedures** to emphasise the compliance on principles of professional ethics which should be enforced by:

- (a) leadership of the firm
- (b) training
- (c) monitoring
- (d) process of dealing with non-compliance

The standard sets out some detailed requirements with regard to independence.

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.

Such policies and procedures should require:

- (a) Engagement partners to provide the firm with relevant information about entity 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

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.

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 HKICPA *Code* and national ethical requirements.

### 2.8.1 Familiarity threat

Last, the HKSQC 1 sets out some specific guidance in relation to the threat of over-familiarity with entities.

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*.

## 3 Specific guidance: Confidentiality



### Topic highlights

HKICPA recognises a duty of confidence and several exceptions to it.

### 3.1 Duty of confidence

A professional accountant has a duty of confidentiality to his client. This principle is encapsulated in the HKICPA *Code of Ethics* which states that a professional accountant who acquires sensitive information in the course of his work, should not use, nor appear to use, that information to his own advantage or to the advantage of any third party with which he is connected.

It is an implied term of any agreement of engagement that the professional accountant will not discuss the entity's affairs to any third party without the entity's consent. There are a few recognized exceptions to this rule of confidentiality discussed below.

### 3.2 Recognised exceptions to the rule of confidentiality

**Obligatory disclosure.** If a member knows or suspects the entity to have committed an offence of treason he is obliged to disclose all the information at his disposal to a competent authority. Local legislation may also require the firm to disclose other infringements.

A professional accountant must disclose information if compelled to do so by a court order (process of law).

If a member is requested to assist the police, the tax authorities or any other authority by providing information about an entity's affairs in connection with inquiries being made he should first inquire under what **statutory authority** the information is demanded. If the demand for information is pressed without any statutory authority the professional accountant should seek the permission of

the entity as to whether the information should be disclosed. If it is declined, legal advice may need to be sought. Any notice served directly to the professional accountant for obtaining documents related to the entity, the professional accountant should read carefully and seek legal advice if necessary.

A member should not voluntarily co-operate with the authorities by assisting with any investigations unless he acts with the entity's consent or is required to do so by law (see the three circumstances in which he is compelled to do so below). If he volunteers the information, it constitutes a breach of confidentiality.

From time to time a professional accountant may know or suspect that an entity has committed a wrongful act and in these circumstances he must give careful thought to his own position. Even in a criminal matter (excluding treason, money-laundering and terrorist offences), he is under no obligation to disclose his information to the relevant authority, but he must ensure that he has not prejudiced himself by, for example, relying on incorrect information.

However, the professional accountant may himself be chargeable with a criminal offence if he acted directly, without lawful authority or reasonable excuse, in such a manner as to impede with intent the arrest or prosecution of an entity whom he knows or believes to have committed an arrestable offence.

A member should not normally appear in court as a witness against an entity unless a written court order is served.

A member should seek legal advice to clarify the legal aspects of his position.

**Voluntary disclosure.** In certain cases voluntary disclosure may be made by the professional accountant:

- To protect the professional accountant's interests (for instance, to defend in litigation against him)
- Where it is in the public's interest
- Where it is authorised by statute
- To non-governmental bodies

**HKICPA Code of Ethics for Professional Accountants**

- To comply with technical standards and ethical requirements
- To comply with the quality review of a member or professional body
- To respond to an inquiry or investigation by a member body or regulatory body (ie disciplinary actions from HKICPA)
- To enable the firm to sue for its fee
- To resist an action for negligence brought against the professional accountant by an entity

Also, having decided that confidential information can be disclosed, professional accountants should consider:

- Whether all relevant facts are known and substantiated
- What type of communication is expected and to whom it should be addressed
- Whether the professional accountant will incur any legal liability as a result of disclosure

### 3.3 Disclosure in the public interest

The courts have never given a definition of 'the public interest'. This means that again, the issue is left to the judgment of the professional accountant. It is often therefore appropriate for the member to seek legal advice.

It is only appropriate for information to be disclosed to certain authorities, for example, the police.

The HKICPA's *Code* states that there are several factors that the member should take into account when deciding whether to make disclosure.

#### HKICPA guidance

- The size of the amounts involved and the extent of likely financial damage
- Whether members of the public are likely to be affected
- The possibility or likelihood of repetition
- The reasons for the entity's unwillingness to make disclosures to the authority
- The gravity of the matter
- Relevant legislation, accounting and auditing standards
- Any legal advice obtained

#### Preparation comments

If you are required to make judgments about whether such a disclosure should be made in a given scenario, you should apply a checklist like this to the scenario to ensure you have shown evidence of your consideration of all the relevant factors.

### 3.3.1 Unlawful acts or defaults by or behalf of a member's employer

If a HKICPA member is aware that his employer or an agent may have committed an unlawful act, he should first draw it to the attention of **internal management at an appropriate level**. If may then report the offence to the board of non-executive directors, or if this option is not available, he may make a report to an external competent authority.

No general obligation exists for a professional accountant who becomes aware of a criminal or unlawful act to disclose this information to a third party without the prior authority from his employer. However, a HKICPA member has a general duty to his employer to act in good faith and with a duty of confidence.

The employed HKICPA member should not generally disclose any confidential information without the entity's consent.

#### Members' Own Relations with Authorities: Criminal Offences

A member himself commits a criminal offence:

- (a) if he incites a client or anyone else to commit a criminal offence; or
- (b) if he helps or encourages a client or anyone else in the planning or execution of a criminal offence; or
- (c) if he agrees with a client or anyone else to pervert or obstruct the course of justice by concealing, destroying or fabricating evidence or by misleading the police by statements which he knows to be untrue

Members are advised **not to attempt to avoid the awkward responsibility** of qualifying the report on the accounts by refusing to report and by resigning.

Members may find that they are requested in their professional capacity by the Independent Commission Against Corruption (ICAC) to assist in investigation of certain corruption allegations, mainly against their own clients. Such assistance usually is requested in the form of furnishing information to ICAC officers either orally or in writing.



### Self-test question 3

You are the senior manager in a medium-size CPA firm. You are responsible for the audits for the following entity and you are reviewing the ethical issues attached to the engagement.

Johnco Co (Johnco) is a manufacturer of kitchen appliances which are exported all over the world.

The following matter has been brought to your attention by the audit senior, who has just completed the planning of the forthcoming audit for the year ending 31 March 2010.

During a discussion with the production manager, it was revealed that there have been some quality control problems with the kitchen appliances manufactured in the middle of the year. It was discovered that some of the stainless steel used in the manufacture of the entity's products did not comply with the international quality standards. Johnco did not recall any of the products which had been manufactured during that time from customers, as management felt that the risk of any injury being caused was remote.

*Required*

Assess the ethical issues raised, and recommend any actions necessary, in respect of the stainless steel used by Johnco Co.

**(The answer is at the end of the chapter)**

## 4 Specific guidance: Conflicts of interest



### Topic highlights

Professional accountants should identify potential conflicts of interest as they could result in ethical codes being breached.

A **conflict of interest** is a situation that may undermine the judgment of a professional accountant. There may be too much personally at stake either for himself or for his firm for the professional accountant to reconcile the stakeholders' or public interest against his own. In these situations:

- Principles of independence, integrity and objectivity are not satisfied
- Promoting personal interest may result in adverse consequences to stakeholders

Firms should take reasonable steps to identify circumstances that could pose a conflict of interest before they happen. A conflict of interest may result in the *Code* being breached (often conflicts of interest give rise to self-interest threats).

The key principle for the firm is that it firm **should not accept an engagement** in which there is likely to be a significant conflict of interest.

### 4.1 Conflicts between professional accountants' and entities' interests

A conflict between professional accountants' and entities' interests may arise if a firm of professional accountants are in direct competition with an entity, or else are involved in a joint venture with a one of the entity's competitors.

In the HKICPA *Code of Ethics* there are rules which state that **members and firms should not accept or continue engagements in which there are, or are likely to be, significant conflicts of interest between members, firms and entities**. This means any form of financial gain as a result of an engagement other than fees for work done will always constitute a significant conflict of interest.

Firms should evaluate the threats arising from a conflict of interest, and unless they are clearly insignificant, they should apply safeguards. The test of whether a threat is significant is whether a reasonable and informed third party, having knowledge of all relevant information, including the safeguards applied, would consider the conflict of interest as likely to affect the judgment and objectivity of the professional accountants involved.

Where any commission is earned by anyone in the firm for business introductions for advice the **this should be disclosed to the entity**. Special care should be taken that any advice given is in the entity's best interests.

## 4.2 Conflicts between the interests of different entities

There is nothing improper in a firm serving two or more entities whose interests are in conflict, as long as the work the firm is not the subject of the conflict.

Where the firm does act for two competing entities it must manage its work so that the interests of one entity do not adversely affect the entity. **Where acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any entity, the appointment should not be accepted or continued.**

Material prejudice may mean information being leaked or for firms to be forced into a corner where they have to choose between the interests of one entity or the other.

The firm must take all reasonable steps to evaluate whether any conflict exists, including implications arising from possession of confidential information and how this may be protected. The firm should continually review its relationships with both prospective and existing entities before accepting or continuing engagements. If aware of possible conflicts between clients or potential clients, the firm should introduce safeguards to try to manage them.

If the relationship ended over two years before, it would be unlikely to constitute conflict.

Where material conflict of interest is identified, the firm should disclose sufficient information to the entity. It is then the decision of the entity as to whether to continue with the firm with the safeguards in place or to seek an alternative provider of the firm's services.

Particular difficulties can arise when it comes to share issues, and takeovers. Professional accountants are often rightly involved in either situation. With regard to **share issues**, firms should never underwrite an issue of shares to the public of an entity they audit. In a **takeover situation**, the professional accountants audit the accounts of both offer or and target company, they must ensure that do *not*

- act as the principal advisers to either party; or
- issue reports assessing the financial statements of either party other than their audit report

If they find they possess material confidential information, they should contact the competent authority.

### 4.2.1 Managing conflicts between entities interests

Disclosure is the most important safeguard in connection with conflicts of interests between entities. The following notifications would be among the safeguards used:

- (a) Disclosing to the entity of nature of the interests/activities that may cause a conflict and obtaining their permission to continue to act in the circumstances acknowledged
- (b) Informing all known relevant parties that the firm is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent
- (c) Seeking the entity's acknowledgement that the firm does not act exclusively for any one entity in the provision of the proposed services

Other safeguards:

- Using separate engagement teams
- Procedures to prevent access of information (such as secure passwords and firewalls)
- Clear procedures for the respective teams on issues of security and confidentiality

- The use of confidentiality agreements signed by the partners and staff
- Regular review of the safeguards by an independent partner
- Advising one or both of the entities to obtain third party independent advice

If adequate disclosure is not possible due to confidentiality restrictions, the firm should not accept or continue the assignment.



#### Self-test question 4

You are an audit manager in MKJ & Co, a local CPA firm. Your firm has been approached by a new entity, Washington, which wants to engage your firm for both audit and advisory work.

Washington has expanded rapidly over the last few years and is planning to list in the next financial year. Washington's financial controller, Mr Otto, is an old friend of one of your senior partners, Mr Man.

Mr Otto has indicated that if Washington can successfully list its shares, the taxation and consultancy work would be performed by your firm. Within your firm's portfolio, you have also an entity which is Washington's rival.

One of your audit seniors has resigned recently to take up the post as Human Resources Manager in Washington. Before any acceptance, Mr Otto has invited your firm to join a very extravagant cocktail party. Washington will distribute its prospectus during the occasion.

*Required*

- (a) Identify and explain the ethical issues in the above situation.
- (b) Give three examples for safeguards within the firm to be used for reducing the threat to independence.

**(The answer is at the end of the chapter)**

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## 5 Conflicts in application of the fundamental principles



### Topic highlights

The *Code of Ethics* gives some general guidance to professional accountants who encounter a conflict in the application of the fundamental principles.

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### 5.1 Matters to consider

The resolution process should include consideration of:

- relevant facts
- ethical issues involved
- fundamental principles related to the matter in question
- established internal procedures
- alternative courses of action

## 5.2 Unresolved conflict

If the matter is unresolved, the member should consult with other appropriate persons within the firm. They may wish to obtain advice from HKICPA or legal advisers.

If after exhausting all relevant possibilities, the ethical conflict remains unresolved, members should consider withdrawing from the engagement, a specific assignment, or members to resign altogether from the engagement.

# 6 Code of ethics applicable to professional accountants in business

Section C of the Code applies to professional accountants in **business**.

A professional accountant in business is a professional accountant employed or engaged in executive or non executive position.

He may be:

- A **salaried employee**, partner, director, owner, working for many organizations
- Solely or jointly responsible for **preparing and reporting financial and other information** for their employers or any persons relying on the information
- Responsible for providing effective financial management and competent advice for investors, creditors, employers or government departments
- Has the responsibility to further **legitimate aims** of their employing organization
- Is expected to encourage an **ethics-based culture** and environment in an employing organization that emphasizes the importance of ethical values; and
- Shall not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles

## 6.1 Examples of threats for professional accountants in business

The following are examples of threat to compliance with the fundamental principles for a professional accountant in business.

### 6.1.1 Self-interest threat

- Holding a financial interest in, or receiving a loan or guarantee from the employing organisation
- Participation in incentive compensation arrangements offered by the employing organisation
- Inappropriate personal use of corporate assets
- Consideration of employment security; and
- Commercial pressure from outside the employing organisation

### 6.1.2 Self-review threat

Consideration of appropriate accounting treatment for a business combination after performing the research study that supported the acquisition decision.

### 6.1.3 Familiarity threat

- The professional accountant in business responsible for selection of the employing organisation's financial reporting when an immediate or close family member employed by the entity makes decisions that would affect the entity's financial reporting
- Long association with business contracts affecting the business decisions; and
- A professional accountant in business accepting a material gift or hospitality, unless the value is trivial and inconsequential

### 6.1.4 Intimidation threat

- **Threat of dismissal or replacement** of the professional accountant in business or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported; and
- The professional accountant in business with a **dominant personality** attempting to influence the decision making process.

### 6.1.5 Advocacy threat

When achieving the legitimate goals and objectives of their employing organisations, professional accountants in business may promote the organisation's goals. If the statements made are neither false nor misleading, the actions would not create an advocacy threat.

## 6.2 Safeguards to comply with the fundamental principles for professional accountants in business

Two types of safeguards are available:

- Safeguards created by the profession, legislation or regulation; and
- Safeguards in the Working Environment

These include:

- The employing **organisation's systems of corporate oversight** or other oversight structures
- The employing organisation's ethics and conduct programs
- Recruitment procedures in the employing organisation emphasising the importance of employing high competent staff
- Implement strong internal controls
- Appropriate disciplinary processes
- Strong leadership to emphasise the importance of ethical behaviour and expect employees to act ethically at all times
- Set policies and procedures to implement and monitor quality of employee
- Update employees for any changes in policies and procedures
- Appropriate training education in implementing such policies
- Set policies and procedures to encourage employee to communicate to senior levels within the employing organisation; and
- Consult additional professional accountant

### 6.3 Potential conflicts

A professional accountant in business is expected to support ethical and legitimate objectives established by the employer and the employer's established rules and procedures. Sometimes, there might be conflict in between a professional accountant's responsibilities to an employing organisation and professional obligations to comply with the fundamental principles.

The professional accountant in business may be under **pressure** to:

- Act contrary to law or regulation, technical or professional standards
- Facilitate unethical or illegal earning management strategies
- Lie to or intentionally mislead others such as auditors or regulators; and
- Issue or be associated with a financial or non-financial report that materially misrepresents the facts

Safeguards **available to eliminate the threat or reduce it to an acceptable level:**

- Obtain advice from the employing organization, an independent professional advisor or a relevant professional body
- The existence of a formal dispute resolution process within the employing organisation; and
- Seek Legal advice

### 6.4 Preparation and reporting of information

A professional accountant in business should prepare or present financial and other information **fairly, honestly and comply to professional standards** so that the information will be understood in its context.

A professional accountant in business shall maintain information for which the professional accountant is responsible so that the information:

- Describes clearly the true nature of business transactions, assets and liabilities
- Classifies and records information in a timely and proper manner; and
- Represents the facts accurately and completely in all material respects

When a professional accountant in business is pressured to become associated with **Self-interest or intimidation threats:**

- Misleading information or misleading information through the actions of others

**Safeguards** may be taken place such as:

- **Consultation with superiors** within the employing organization or with a relevant professional body

If not possible to apply safeguards, the accountant should refuse to remain in association with information they consider. The professional accountant may also consider resignation.

### 6.5 Acting with sufficient expertise

A professional accountant in business **should not intentionally mislead an employer** as to the level of expertise or experience possessed and should seek appropriate advice and assistance when required.

Circumstances when there is a threat to the performance of duties with the appropriate degree of competence and due care are:

- Insufficient time for properly performing or completing the relevant duties
- Incomplete, restricted or otherwise in adequate information for performing the duties properly

- Insufficient training, experience and education; and
- Inadequate resources for the proper performance of the duties

Safeguards **available to eliminate the threat or reduce it to an acceptable level:**

- Obtain additional advice and training
- Ensure sufficient time to complete duties; and
- Consult, where appropriate, superior, independent experts, regulatory and professional body

When threats cannot be eliminated or reduced to an acceptable level, professional accountants in business shall determine whether to refuse to perform the duties in question.

## 6.6 Financial interests

Professional accountants in business or their immediate or close family members may face self-interest threats which would create threat to objectivity.

Situations such as:

- Holds a **direct or indirect financial interest** in the employing organisation and the value of such financial interest could be directly affected by decisions made by the professional accountant
- Eligible for a **profit related bonus** which could be directly affected by the professional accountant's decisions
- Holds directly or indirectly **share options** in the employing organisation which will be converted; and
- Share options will be qualified when performance targets are met in the employing organisation

Safeguards **available to eliminate the threat or reduce it to an acceptable level:**

- Disclose all relevant interests and any future plans to trade in relevant shares, to those charged with governance
- Set policies and procedures an independent committee to determine the level or form of remuneration of senior management
- Consult, where appropriate, superior, independent experts, regulatory and professional body, those charged with governance
- Internal and external audit procedures; and
- Up-to-date education on ethical issues and the legal restrictions and other regulations around potential insider trading

A professional accountant in business shall neither manipulate information nor use confidential information for personal gain.

## 6.7 Inducements

Inducements would cause **self-interest threat and intimidation threat**. The professional accountant in business or their immediate close family member may be offered, or may offer, inducements such as gifts, hospitality or any other preferential advantages.

### Receiving an offer

The **self-interest threat** (or confidentiality) occurs when an inducement is made in an attempt to:

- unduly influence actions or decisions
- encourage illegal or dishonest behaviour ; and
- obtain confidential information

**An intimidation threat** (or confidentiality) will occur when an inducement is accepted and followed by threats to make that offer public and damage the reputation of the professional accountant in business or his immediate family members.

There is no significant threat to compliance with the fundamental principles if the offer is made in the normal course of business.

**The inducement shall not be accepted** when the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards.

### **Making an offer**

A professional accountant in business **should not offer an inducement** to improperly influence the professional judgment of a third party.

When an unethical inducement is offered from the employing organisation, the professional accountant should follow the principles and guidance regarding ethical behaviour.

Actions to be taken when there is an inducement offered:

- Inform higher levels of management or those charged with governance
- Inform third parties of the offer – ie a professional body; and
- Advise immediate or close family members of the situation after receiving such inducements

## **7 Other issues**

### **7.1 Client acceptance**

Before accepting a **new engagement**, the professional accountant in public practice should consider whether **there is any threat to compliance with the fundamental principles**, that is any potential threats to integrity or professional behaviour, for example, entity involvement in illegal activities.

The significance of any threats should be evaluated and safeguards should be applied to eliminate them or reduce them to an acceptable level.

If it is not possible to reduce the threat to an acceptable level, the professional accountant in public practice should decline the engagement.

For recurring entity engagement, acceptance decisions should be reviewed annually.

### **7.2 Engagement Acceptance**

A professional accountant must only accept engagement that he is **competent to perform** and safeguards may be applied :

- Obtain appropriate understanding of the **nature of the client's business**, complexity of the operations, specific requirement of the engagement, the relevant industries and the scope of work
- Obtain and be **familiar with the relevant regulations** or reporting requirement
- Assigning **sufficient competent staff**
- Consider the use of **experts**
- Consider the **deadline**; and
- Comply with quality control policies and procedures to provide reasonable assurance that specific engagements are accepted only when they can perform competently.

### 7.3 Changes in professional appointment

A professional accountant should determine whether there are any reasons for not accepting the engagement. Safeguards may be applied such as:

- Discuss client's affairs with existing accountant
- **Enquire existing accountant** for any information for the proposed accountant to be aware of before deciding whether to accept the engagement
- Any initiation to contact the existing accountant, there must be client's consent; and
- Any client's information to be released by the existing client, there must be client's consent or there is legal or ethical requirement for such disclosure.

### 7.4 Marketing professional services

The professional accountant should be honest and truthful and should not exaggerate any claims of services offered, qualifications and experiences or make disparaging references in comparison with the work of another professional accountant.

### 7.5 Custody of entity's assets

A professional accountant should not keep, in custody, the entity's monies or other assets unless permitted to do so. If the professional accountant, for instance, is entrusted with money or other assets belonging to others, the following safeguards should be applied:

- Keep it separately from personal and firm's assets
- Only use the assets for intended purpose
- Keep proper accounting records for the assets
- Comply with laws and regulations

### 7.6 Integrity, objectivity and independence in insolvency

#### Receivership and liquidator appointment

When a material professional relationship with an entity exists, no partner in or employee of the firm should accept appointment as receiver or as receiver and manager of that entity or liquidator of the entity if the entity is insolvent or a trustee in bankruptcy.

#### A material professional relationship

Partner/employee of the firm is prohibited from appointment as receiver, manager, liquidator or trustee if there has been a material professional relationship during the previous two years.

#### Material professional work

Audit work of such overall significance that a member's objectivity in carrying out a subsequent insolvency appointment could be or could reasonably be prejudiced.

If the company goes into liquidation the company's rights remain **vested** in the company.

The auditor of a company which is in liquidation may be **approached by the police for assistance in enquiries (Still need to consider confidentiality)**.

#### Audit following receivership

Where a partner in or an employee of a practice has been receiver of any of the assets of a company, neither the practice nor any partner in or employee of the practice should accept appointment as auditor of the company, or of any company which was under the control of the receiver, for any accounting period during which the receiver acted or exercised control.

Acceptance of an insolvency appointment in relation to more than one company in a group of companies or association may raise issues of **conflict of interest**.

## Topic recap

- Professional accountants require an ethical code because they hold positions of trust, and people rely on them.
- The HKICPA's *Code of Ethics* gives examples of a number of situations where independence might be threatened and suggests safeguards to independence.
- HKICPA recognises a duty of confidence and several exceptions to it.
- HKICPA gives further guidance on disclosure 'in the public interest'. Firms should usually seek legal advice before making disclosures.
- Professional accountants in practice or in business should identify potential conflicts of interest as they could result in ethical codes being breached.

## Answers to self-test questions

### Answer 1

- (a) When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee deemed to be appropriate.

The fact that the other firm quotes a fee 50 per cent lower than your firm is not in itself unethical.

If S&S Partners follows the other firm to lower fee by 50 per cent, there may be threats to compliance with the fundamental principles arising from the low level of fees quoted.

For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

The significance of such threats will depend on factors such as the level of fee quoted and the services to which it applies. The difference of 50 per cent is likely to be other than insignificant, unless S & S Partners' preliminary fee estimate is itself excessively high.

If S & S Partners revises its fee quotation in order to win the tender, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards which may be adopted include:

- (i) making the entity aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee
  - (ii) assigning appropriate time and qualified staff to the task
- (b) The audit tender should be reviewed thoroughly to ensure that the fee estimate is a fair reflection of the time required and the quality of staff needed to adequately perform the audit. It may be possible to make legitimate cost savings and reduce the fee a little, as it may represent a fair fee for the service offered. If so, it should be submitted. There should be no attempt to compete with the other firm based **purely** on price.

### Answer 2

- (a) The Code of Ethics ('the *Code*') sets out that a professional accountant should comply with the fundamental principles. The relationship between Mr Chan and Mr Yeung may create a self-interest threat, an intimidation threat and a familiarity threat.

If familiarity threat arises, Mr Chan would be too sympathetic to the Mr Yeung's interest to be objective to audit work. Intimidation threat which occurs when Mr Chan may be deterred from acting objectivity and exercising professional skepticism by threats, actual or perceived, from Mr Yeung or other directors. The significance of the threat will depend on Mr Chan's responsibilities in the engagement, the closeness of the relationship and Mr Yeung's role in ABC. Since Mr Yeung is acting as the financial controller who has direct and significant influence on the preparation of ABC's accounting records or financial statements and he is about to become Mr Chan's son-in-law, the threat appears to be significant.

Mr Chan should consider whether the threats to independence are **so significant** that no safeguard could reduce the threats to an acceptable level, in which case, he should resign.

If Mr Chan does not feel it necessary to withdraw from the engagement team, appropriate safeguards should be implemented ie restructure the responsibilities of the engagement team add quality control reviews.

- (b) Alan should comply the fundamental principle of confidentiality. He should not disclose any information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose.

The firm is required to disclose information if compelled by process of law ie court order. Alan should first ascertain whether or not the person requesting information has a statutory right to demand it.

In this case, Dave does not seem to have the statutory right to request information from Alan unless there is a court order granted. Alan should not voluntarily disclose the information before taking appropriate legal advice.

- (c) It is a fundamental ethical principle that a professional accountant has a continuing duty to maintain professional knowledge and skill. According to the case, the firm does not have any listed entities at present, the firm should consider whether the team members have professional competence to perform the potential listing work.

The facts that BT would be the firm's first listed entities, if it is successfully listed, may cause a self-interest threat as BT's fee would account for approximately 10 per cent of the firm's annual revenue.

Appropriate safeguards should be applied such as:

- (i) Discuss the fee level with the audit committee and those charged with governance
- (ii) Reduce undue dependence by only performing the audit
- (iii) External quality review

If there are no safeguards, the firm should decline the engagement.

### Answer 3

Management has decided not to recall any products and this indicates problems with the management integrity. The defects in the products have potential effects on Johnco's customers. It would still be ethically appropriate to announce the problem, allowing customers to return potentially harmful products. There might be still inventories that are defected in Johnco's warehouses, waiting to be sold. Professional accountants should try to explain to management the reasons why they should disclose and should convince management that this is the way to proceed.

If management still refuse to make a disclosure, the professional accountants should consider their obligatory duty of confidentiality. The HKICPA's *Code of Ethics* recognises that information discovered while performing a professional engagement must not be disclosed without the entity's consent unless there is a legal or professional right or duty to disclose.

In deciding whether to disclose in the public interest, the professional accountants should consider the reasons for the entity's unwillingness to disclose, the materiality of the matter ie the probability of harm being caused to the customers, and the relevant laws and regulations being breached.

The professional accountants could consider the option of resigning from the audit. The firm could inform audit committee or board of directors the reason for the resignation, including details of the faulty products, disagreements with the management and the lack of management integrity.

Finally, the lack of management integrity also affects on the nature, extent and timeliness of audit procedures that are currently being planned. Any defective inventory still held by Johnco should be written off as obsolete goods, and provisions may be necessary for refunds of returned products or future claims by customers. The financial statements may need to contain disclosures relating to contingent liabilities, or provisions may need to be recognised in respect of damages claimed by customers in the event of any injuries occurring and legal action being taken against Johnco.

## Answer 4

### (a) Washington – ethical issues

In accordance with the *Code of Ethics*, MKJ & Co should consider ethical issues in its entity acceptance procedures. In considering accepting Washington as its client entity, MKJ & Co should consider any relevant threats to independence which may impair the firm's objectivity and independence.

#### Self-interest threat

There are no details mentioned regarding the fee income obtained from Washington. However, as Washington will soon list, MKJ should ensure no more than 10 per cent of its recurring practice income (assuming advisory work, taxation and consultancy work to be performed annually) should be derived from Washington. Obtaining over 10 per cent could indicate undue dependence on an entity and objectivity would be likely to be impaired resulting in a self-interest threat.

MKJ & Co should review its proposed fee and should consider whether it should limit other services so that independence is not impaired. An annual review would be required on Washington if the fee is close to 10 per cent of its total fee.

#### Self-review threat

A self review threat may be created when MKJ & Co provides advisory work and consultancy work for Washington, especially when the works are on financial accounting.

#### Familiarity threat

The familiarity threat may occur when there exists a close relationship with an entity, its directors, officers or employees; a firm or a member of the assurance team becomes too sympathetic to the entity's interest.

In accordance with the facts, Mr Otto, Washington's financial controller is an old friend of one of the senior partners, Mr Man. The firm should consider whether a different partner should take the lead on Washington's work.

#### Conflict of interest

Within MKJ & Co's portfolio, there is an entity who is also a competitor of Washington. There is nothing improper in a firm having two or more entities whose interests are in dispute, as long as the work of the firm does is not the subject of the dispute.

In this case, MKJ & Co's work should be managed so as to avoid the interests of one entity adversely affecting the other. The firm should review its relationship with prospective entity ie Washington and the rival entity before accepting/continuing the engagement. If a material conflict of interest is identified, the firm should disclose sufficient information to entities so that they can make an informed decision as to whether to continue with firm.

#### Advocacy threat

Since Washington is about to list, if MKJ & Co agrees to attend the cocktail party, there may be threats to independence through an advocacy threat. This occurs when the firm may be perceived to be a promoter of shares in Washington, as the prospectus is being distributed during the party. The firm should consider how likely this perception is, for example, whether their name appears on the prospectus or the party invitation. In addition, they should consider whether hospitality at an 'extravagant cocktail party' is 'clearly insignificant'.

### (b) Safeguards:

#### Self-interest threat – fee

MKJ & Co should start monitoring when the fee is approaching 10 per cent of its total fee of the firm. If there is undue dependence on Washington, MKJ should be selective of the engagements.

MKJ & Co should install appropriate safeguards especially the firm should not act in the management role, making managerial decisions. The rule should be strictly complied as Washington would be listed in next financial year.

**Familiarity threat**

Familiarity threat may have been created. Mr Man should not be assigned as the engagement partner on the audit.

One of the audit seniors has become employee of Washington, however since the employee is to become Human Resources Manager, there is very little direct and significant influence over the financial accounting aspect. MKJ & Co may instruct the partner in charge to modify the audit plan normally used as a safeguard, but this appears to be an insignificant risk.

**Conflicts of interest**

Some of the most common safeguards to manage this conflict of interest would be using different engagement teams to handle Washington's work and its rival's work. The firm should have standing instructions to prevent the leakage of confidential information or prevent access to information.

**Advocacy threat**

MKJ & Co should not participate in any activities relating to the promotion of the shares of Washington and should make clear to Washington's management that they cannot be perceived to.

## Exam practice



You are the manager in charge of the audit of the financial statements of Super Gain Limited (Super Gain). Super Gain is a private company incorporated in Hong Kong and is engaged in the logistics business. Management of Super Gain plans to offer its securities on The Stock Exchange of Hong Kong Limited (the 'Stock Exchange') in the near future and has asked your firm to submit a proposal, including fee structure, for appointment as Super Gain's reporting accountants.

The Finance Director of Super Gain has asked you to include the following in your proposal:

- (a) Your firm agrees to offer a flexible price structure of HK\$1.5 million, payable in three instalments with the last instalment payable only upon the successful listing of Super Gain's shares on the Stock Exchange showing your firm's commitment in sharing risks with Super Gain in the flotation exercise; and
- (b) Your firm agrees not to charge for any additional work that might be found necessary during the flotation exercise; and
- (c) Your firm agrees to participate in the Super Gain road show with Super Gain's sponsor, and assist management to respond to questions from interested investors on Super Gain's financial matters.

*Required*

Comment on the potential issues surrounding your proposal to serve as the reporting accountants of Super Gain and how you would explain to Super Gain's Finance Director that the proposal has to be revised. **(13 marks)**

**(13 marks - approximately 23 minutes)**



# Appendix 2: Example of an Audit Engagement Letter



## Example of an Audit Engagement Letter

*The following is an example of an audit engagement letter for an audit of general purpose financial statements of limited company clients which are incorporated in Hong Kong under the Companies Ordinance. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this HKSA. It will need to be varied according to individual requirements and circumstances, for example to the special reporting requirements of regulated entities. It may be appropriate to seek legal advice that any proposed letter is suitable.*

To the directors of \_\_\_\_\_:

### Objective of services

- 1.1 You have requested that we audit the financial statements of [ABC Company Limited]. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

### Responsibilities of directors

- 2.1 Our audit will be conducted on the basis that you acknowledge and understand that you have responsibility:
- a. To maintain proper books of account of the company;
  - b. For the preparation of financial statements which give a true and fair view in accordance with [insert applicable financial reporting framework] [Hong Kong Financial Reporting Standards][Hong Kong Financial Reporting Standard for Private Entities] and have been prepared in accordance with the Companies Ordinance;
  - c. For such internal control as you determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
  - d. To provide us with:
    - (i) Access to all information of which you are aware that is relevant to the preparation of the financial statements such as company's books of account and all other relevant records and documentation, including minutes of all management and shareholders' meetings and other matters;
    - (ii) Additional information that we may request from you for the purpose of the audit; and
    - (iii) Unrestricted access to persons within the company from whom we determine it necessary to obtain audit evidence.

### Responsibilities of the auditor

- 3.1 We have a statutory responsibility to report to the members whether in our opinion the financial statements give a true and fair view and whether they have been properly prepared in accordance with the Companies Ordinance. In arriving at our opinion, we are required to consider the following matters, and to report on any in respect of which we are not satisfied:

- a. whether proper books of account have been kept by the company and proper returns adequate for our audit have been received from branches not visited by us;
- b. whether the company's balance sheet and profit and loss account are in agreement with the books of account and returns; and
- c. whether we have obtained all the information and explanations which we consider necessary for the purposes of our audit.

In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in our report. For example, where the financial statements do not give details of directors' remuneration or of loans to officers, the Companies Ordinance requires us to disclose such matters in our report.

- 3.2 We have a professional responsibility to report if the financial statements do not comply in any material respect with *[insert applicable financial reporting framework]* *[Hong Kong Financial Reporting Standards]**[Hong Kong Financial Reporting Standard for Private Entities]*, unless in our opinion the noncompliance is justified in the circumstances. In determining whether or not the departure is justified, we consider:
  - a. whether the departure is required in order for the financial statements to give a true and fair view; and
  - b. whether adequate disclosure has been made concerning the departure.

#### Scope of audit

- 4.1 Our audit will be conducted in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by you, as well as evaluating the overall presentation of the financial statements.
- 4.2 Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with HKSA's.
- 4.3 In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit. Any such report may not be provided to third parties without our prior written consent. Such consent will be granted only on the basis that such reports are not prepared with the interests of anyone other than the company in mind and that we accept no duty or responsibility to any other party as concerns the reports.
- 4.4 As part of our audit procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the audit on matters having a material effect on the financial statements. In connection with representations and the supply of information to us generally, we draw your attention to section 134 of the

Companies Ordinance under which it is an offence for an officer of the company to mislead the auditor.

- 4.5 In order to assist us with the examination of your financial statements, we shall request sight of all documents or statements, including the chairman's statement, operating and financial review and the directors' report, which are due to be issued with the financial statements. We are also entitled to attend all general meetings of the company and to receive notice of all such meetings.
- 4.6 The responsibility for safeguarding the assets of the company and for the prevention and detection of fraud, error and non-compliance with law or regulations rests with you. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or books of account (including those resulting from fraud, error or non-compliance with law or regulations), but our examination should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist.
- 4.7 (Where appropriate - Note) We shall not be treated as having notice, for the purposes of our audit responsibilities, of information provided to members of our firm other than those engaged on the audit (for example information provided in connection with accounting, taxation and other services).
- 4.8 Once we have issued our report we have no further direct responsibility in relation to the financial statements for that period. However, we expect that you will inform us of any material event occurring between the date of our report and that of the Annual General Meeting which may affect the financial statements.

#### **(Consolidated financial statements)**

5. As the auditor of the holding company we are required to report, in similar terms to those outlined in paragraph 3.1 above, on the group's consolidated financial statements, which comprise the financial statements of the holding company and its subsidiaries. In order to express an opinion on group's consolidated financial statements which include the financial information of subsidiaries, joint ventures or associated companies of which we are not the auditor, it will be necessary for us to communicate directly with the other auditor(s) concerned to satisfy ourselves that:
- a. so far as is practicable, there is uniformity within the group in the application of accounting policies;
  - b. the consolidated financial statements give the information required by the Companies Ordinance, applicable accounting standards and any other legislation or non-statutory requirements affecting the presentation of financial statements; and
  - c. all material aspects of the consolidated financial statements have been subjected to an audit examination, the nature and extent of which is adequate and reasonable, in our view, for the purpose of forming an opinion on the group's consolidated financial statements.)\*

#### **Reporting**

- 6.1 *[Insert appropriate reference to the expected form and content of the auditor's report.]*
- 6.2 The form and content of our report may need to be amended in the light of our audit findings.

**(Other services)**

7. You have requested that we provide other services in respect of ..... The terms under which we provide these other services are dealt with in a separate letter.)\*

**Fees**

8. Our fees are computed on the basis of the time spent on your affairs by the partners and our staff and on the levels of skill and responsibility involved plus out-of-pocket expenses. Unless otherwise agreed, our fees will be billed at appropriate intervals during the course of the audit and will be due on presentation.

**Agreement of terms**

- 9.1 Once it has been agreed, this letter will remain effective, from one audit appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.
- (9.2 Since the terms of our engagement as auditors of the subsidiaries listed in the attached appendix are the same, we will not send separate letters to the board of directors of each subsidiary. We would therefore be grateful if you would forward copies of this letter to the boards of directors of each such subsidiary and confirm that these boards have also agreed and confirmed their acceptance of this letter.)\*

Yours faithfully,

ABC & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

Date

We agree to the terms of this letter.

(Signed)

.....  
Director, for and on behalf of the board of \_\_\_\_\_

Date

\_\_\_\_\_

\* Delete where not applicable.

**(Source: Members' Handbook – Volume III HKSA 210 (Clarified))**

Appendix 3:  
Audit of Financial  
Statements Prepared in  
Accordance with the Small  
and Medium-sized Entity  
Financial Reporting  
Standard (SME – FRS)



## **7 Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS)**

PN 900 (Clarified) is issued to reflect compliance with the requirements of HKSA 700 (Clarified) 'Forming an Opinion and Reporting on Financial Statements', HKSA 705 (Clarified) 'Modifications to the Opinion in the Independent Auditor's Report' and HKSA 706 (Clarified) 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', for audits of financial statements for periods beginning on or after 15 December 2009.

### **7.1 Purposes of the PN**

The PN gives guidance on the applicability of HKSAs to the audit of financial statements prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS). The Small and Medium-sized Financial Reporting Framework (SME-FRF) sets out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the SME-FRS.

### **7.2 Definition of SME-FRF**

#### **Qualifying Entities in accordance with the SME - FRF**

- (a) a company incorporated under the Companies Ordinance qualifies for reporting under the SME-FRF if it satisfies the criteria set out in section 141D of that Ordinance; and
- (b) an entity, other than a company incorporated under the Companies Ordinance, subject to any specific requirements imposed by the law of the entity's place of incorporation and subject to its constitution, qualifies for reporting under the SME-FRF when the entity does not have public accountability as defined in the SME-FRF, and:
  - (i) all of its owners agree to prepare the financial statements in accordance with the SME-FRS; and
  - (ii) the entity is considered to be an SME in terms of its size under the SME-FRF.

It follows that all HKSAs are applicable to the audit of financial statements prepared in accordance with the SME-FRS.

### **7.3 The application of Section 141D of the Companies Ordinance**

Section 141D (Companies Ordinance) exempts certain private companies from complying with the **full disclosure requirements** of the Companies Ordinance. These companies do not have to produce financial statements which show a true and fair view of the state of the company's affairs and of its profit or loss for the year.

As an alternative, the auditor is required to report on whether the company's statement of financial position and accompanying notes show a true and correct view of the state of the company's affairs.

### **7.4 Audit procedures**

It is management's responsibility to ensure that the entity qualifies for reporting under the SME-FRF.

An auditor would design and perform audit procedures to obtain sufficient appropriate audit evidence as to whether the entity qualifies for reporting under the SME-FRF. The auditor shall comply with all HKSAs relevant to the audit. The same procedures would be adopted for all audits regardless of the financial reporting framework adopted.

For a company incorporated in Hong Kong applying section 141D, in addition to carrying out the audit procedures required by HKSAs, the auditor would ensure:

- (a) that the company is entitled to take advantage of the exemptions permitted under section 141D(3)
- (b) that the shareholders have entered into a new unanimous written agreement for the particular financial year under review; and
- (c) that the statement of financial position and accompanying notes contain the information required under the Eleventh Schedule of the Companies Ordinance.

### 7.5 Audit Report

An auditor is required to comply with the requirements of HKSA 700 (Clarified), HKSA 705 (Clarified) and HKSA 706 (Clarified). In an auditor's report on the financial statements prepared in accordance with the SME-FRS, the auditor expresses an opinion as to whether the financial statements have been properly prepared, in all material respects, in accordance with the SME-FRS.

For any company incorporated in Hong Kong applying section 141D, the standard requires the auditor's report to state:

- (a) whether or not the auditor has obtained all the information and explanations which they have required; and
- (b) whether, in their opinion, the statement of financial position (together with the notes thereon) referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

When the auditor is unable to give an unmodified opinion, the audit report shall be modified in accordance to HKSA 705 (Clarified) or HKSA 706 (Clarified).