(6) Evaluate the circumstances and perform additional procedures to ensure the completeness of related party transactions.

(7) Ensure the company discloses the identified related party transactions in the company's financial statements.

(c) I will perform the following procedures so as to ensure completeness of related party transactions:

(1) Review prior year's working papers to identify known related parties and any previously identified related party transactions.

(2) Review the company's procedures designed to identify related parties and transactions.

(3) Inquire as to the affiliation of directors and officers with other parties having business dealings with the company.

(4) Review the company's statutory records to identify any related parties and transactions with these parties.

(5) Inquire of other auditors currently involved in the audit, or previous auditors, as to their knowledge of additional related party transactions.

Exam practice

Hong Kong Toys Company Limited — 29 minutes

Hong Kong Toys Company Limited ("HKT") is a company incorporated under the Hong Kong Companies Ordinance. It is engaged in the business of the design and manufacturing of toys. HKT is owned by the Chan family, with five members of the family each holding 15% to 30% of the equity interest in HKT. HKT rents its office premises from one of the shareholders at HK$500,000 per month. All the five family members are appointed directors and are remunerated for services rendered to the company. You are the engagement partner for the audit of HKT's financial statements for the year ended 31 December 20X9.

Required

Determine the procedures your team would perform regarding:

(a) related party relationships; and **(8 marks)**

(b) related party transactions of HKT. **(8 marks)**

(Total = 16 marks)

HKICPA February 2010

X Limited — 16 minutes

X Limited operates a local chain of five retail shops in Hong Kong mainly selling a particular brand of household electric appliances, known as Brand A. Brand A is manufactured and supplied by A Multinational Corporation ("A Corp") based in Japan.

X Limited has an exclusive distribution agreement with A Corp to sell and distribute Brand A products in Hong Kong. The current agreement will end on 31 March 20X1, and A Corp has already expressed the intention to set up its own distribution network in Hong Kong.

As part of the sales tactics, X Limited provides a two-year comprehensive warranty to customers at its own cost for all Brand A products. A provision covering the anticipated costs to be incurred by X Limited to honour the warranty has been booked in the financial statements.

Required

In the context of the above case particulars, and from the perspective of the auditor of X Limited, discuss the main issues which could cast doubt on the going concern of X Limited for the year ended 31 December 20X0.

(9 marks)

HKICPA June 2012

chapter 17

Audit reporting

Topic list

Learning focus

The auditor's report is the final product of the audit process: the final result produced by auditor, who should take care about the type of reports and the wordings within the report. As stated in HKSA 200 (Clarified), the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

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* are all effective for audits of financial statements for periods beginning on or after 15 December 2009.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.13	**Reporting**	3
2.13.03	Explain and analyse the format and content of unmodified audit reports	
2.13.04	Explain and analyse the format and content of modified audit reports	

1 The auditor's report on financial statements

Topic highlights

The auditor is required to produce an **auditor's report** at the end of the audit which expresses his **opinion** on the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.

1.1 The new Hong Kong Companies Ordinance

Offences relating to contents of auditor's reports

The new Companies Ordinance ("the new CO") introduces a **new offence** relating to **omissions in an auditor's report** under s. 408.

If the auditor is of the opinion that the financial statements of a company are not in agreement with its accounting records in any material respect, or the auditor has **failed to obtain all the information or explanations** that are necessary and material for the purpose of the audit ("the specified statements"), the auditor must state that fact in the auditor's report pursuant to s. 407 of the new CO. There are similar requirements in s. 141 of the Companies Ordinance (Cap. 32) but there is no sanction for contravention of the requirement. The offence in s. 408 will safeguard the reliability and integrity of auditor's reports and enhance enforcement.

Under the new CO, an auditor who knowingly or recklessly causes any of the specified statements to be omitted from an auditor's report commits an offence under s. 408 and is liable to a fine not exceeding $150,000.

The offence in s. 408 will safeguard the reliability and integrity of auditor's reports and enhance enforcement.

Who may be held liable for the offences under s. 408(1) of the new Companies Ordinance?

Any of the persons specified below commits the offence if the person knowingly or recklessly causes any of the specified statements to be omitted from an auditor's report:

- If the auditor is a natural person, the auditor and every employee and agent of the auditor who is eligible for appointment as auditor of the company;
- If the auditor is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company;
- If the auditor is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company.

1.2 HKSA 700 (Clarified) guidance on auditor's report

HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements* establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. The auditor must review and assess the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements.

HKSA 700.6

This evaluation involves considering whether the financial statements have been **prepared** in accordance with an **applicable financial reporting framework**, being HKASs and HKFRSs and the Hong Kong Companies Ordinance. HKSA 700 (Clarified) states that the objectives of the auditor are to:

(a) form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained, and

(b) express clearly that opinion through a written report that also describes the basis for that opinion.

1.3 Forming an opinion on the financial statements

HKSA 700.11

In order to form that opinion, the auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework and shall conclude as to whether he has obtained **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

1.3.1 Sufficient appropriate audit evidence

HKSA 330 (Clarified) requires that the auditor shall conclude whether sufficient appropriate audit evidence has been obtained. The auditor shall consider whether all relevant audit evidence corroborate with the financial statement assertions. The auditor shall take into account of the following:

(a) Significance of potential misstatement in the assertion and the likelihood of having a material effect on the financial statements

(b) Effectiveness of management's responses and controls

(c) Previous years' audit experience

(d) Results of audit procedures performed

(e) Source and reliability of the available information

(f) Persuasiveness of the audit evidence

(g) Auditor's understanding of the entity and its environment, including internal controls

If the auditor **cannot obtain sufficient appropriate audit evidence** to a material financial statement assertion, the auditor shall perform further audit procedures. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a **qualified opinion or disclaim the opinion** on the financial statements.

1.3.2 Financial reporting framework

The financial reporting framework may be:

(a) a **fair presentation framework** – this term is used to refer to a financial reporting framework that requires **compliance with the requirements of the framework** and:

(i) acknowledges that to achieve fair presentation of the financial statements it may be necessary for management to provide disclosures beyond those specifically required by the framework

(ii) acknowledges that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements (extremely rare circumstances).

(b) **Compliance framework** – this term is used to refer a financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgements as above.

The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the **qualitative accounting aspects**. The following are some of the requirements for evaluation:

(i) Disclosure and consistency of significant accounting policies

(ii) Reasonableness of management's estimates

(iii) The information fairly presented in the financial statements is relevant, reliable, comparable and understandable

(iv) Effect of material transactions and events on the information conveyed in the financial statements

(v) Appropriate titles of the financial statements

(vi) Overall presentation is fair including overall structure and content of the financial statements

1.3.3 Uncorrected misstatements

In accordance with HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit*, the auditor must consider whether uncorrected misstatements are material, individually or in aggregate and the effect that these will have on the audit opinion.

1.4 Basic elements of the auditor's report

HKSA 700.21-42

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding and helps identify unusual circumstances when they occur. The auditor's report includes the following basic elements, usually in the following layout:

Basic elements of audit report	Explanation
Title	The title should indicate that the report is by an independent auditor to confirm all the relevant ethical standards regarding independence have been met. This helps readers to identify the auditor's report and to easily distinguish it from reports that might be issued by others.
Addressee	The auditor's report should be addressed as required by the circumstances of the engagement, but is likely to be the shareholders or board of directors.
Introductory paragraph	This should identify the entity being audited, state that the financial statements have been audited, identify the financial statements being audited, specify the date and period covered by the financial statements and refer to the summary of significant accounting policies and other explanatory information.
Statement of directors' responsibility	There must be a heading "Directors" [or other appropriate term] responsibility for the financial statements'. The report must contain a statement that directors are responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework, and for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement whether due to fraud or error.

Basic elements of audit report	Explanation
Statement of auditor's responsibility	The auditor's report shall include a section with the heading "Auditor's responsibility". The report must state that the auditor is responsible for expressing an opinion on the financial statements. The report should explain that the auditor adhered to HKSAs and ethical requirements (ie the *Code of Ethics*) and that the auditor planned and performed the audit so as to obtain reasonable assurance that the financial statements are free from material misstatements. The report should describe the audit as including: • Performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements • The exercise of the auditor's judgment of risks of material misstatements whether due to fraud and how that assessment is made • Consideration of internal control relevant to the entity's preparation and fair presentation of the financial statements but not expressing an opinion on the effectiveness of the entity's internal control • The evaluation of the appropriateness of the accounting policies used, the reasonableness of estimates and the overall presentation of information in the financial statements • The auditor's beliefs on whether the auditor has obtained sufficient and appropriate audit evidence to provide a basis for the auditor's opinion
Opinion paragraph	The auditor's report shall include a section with the heading "Opinion". If the auditor concludes that the financial statements give a true and fair view, he should express an unmodified opinion which states that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the applicable financial reporting framework.
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this should be done in an additional paragraph below the opinion paragraph. The paragraph should be stated as "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section.
Date of the report	The report must be dated. This informs the reader that the auditor has considered the effect on the financial statements and on his report of events or transactions about which he became aware that occurred up to that date. The date should not be earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.
Auditor's address	The location where the auditor practises must be included. This is usually the city where the auditor has his office.
Auditor's signature	The report must contain the auditor's signature, whether this is the auditor's own name or the audit firm's name.

1.5 Other auditing standards

Apart from complying with HKSAs in the conduct of the audit, an auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction ("other auditing standards") as well. The auditor should ensure there is no conflict between the requirements in the other auditing standards and those in HKSAs. The auditor's report of specific jurisdictions shall identify other auditing standards when referring to law or regulation and shall be read as reference to the other auditing standards.

1.6 Supplementary information presented with the financial statements

The auditor shall evaluate whether such supplementary information is clearly differentiated from the audited financial statements if supplementary information is presented with the audited financial statements.

The auditor's opinion should cover the fact when supplementary information cannot be clearly differentiated from the audited financial statement due to its nature.

2 Unmodified auditor's reports

Topic highlights

An **unmodified opinion** must be expressed when the auditor concludes that the financial statements are prepared, in all material aspects in accordance with the applicable financial reporting framework.

An unmodified opinion also indicates implicitly that any **changes in accounting policies** or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

The auditor should review the conclusions drawn from the audit evidence obtained as the basis for the expression of his opinion on the financial information. This review and assessment involve forming an overall conclusion as to whether:

(a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied

(b) the financial information complies with the relevant legislation and regulations

(c) there is adequate disclosure of all material matters for a true and fair presentation of the financial information

The following is an example of the auditor's report on an entity incorporated in Hong Kong:

Independent auditor's report to the shareholders of ABC Ltd

(Incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages 10 to 40, which comprise the statement of financial position as at 31 December 201X, and the statement of profit or loss and other comprehensive income, statement of changes in equity or statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' responsibility for the financial statements

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit 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. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 201X and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

XYZ & Co.
Certified Public Accountants
Hong Kong

15 February 201Y

This section has introduced you to the standard unmodified audit report. The following section looks at how the audit report is affected when problems of varying severity arise in the audit, resulting in modified reports.

3 Modified auditor's reports

Topic highlights

The auditor expresses a modified opinion when the auditor concludes that the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to form a conclusion.

3.1 Types of modifications

HKSA 705.2

HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report* deals with situations where the auditor cannot issue an unmodified opinion.

HKSA 705 (Clarified) establishes three types of modified opinion, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) the **materiality** of the nature of the matter giving rise to the modification

(b) the auditor's judgment about the **pervasiveness** of the effects or possible effects of the matter on the financial statements

When the auditor expects to modify the opinion in the auditor's report, he shall **communicate** with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

Pervasive is used to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgment:

- are not confined to specific accounts, elements or items of the financial statements
- represent a substantial proportion of the financial statements
- for disclosures, are fundamental to users' understanding of the financial statements

3.2 Matters that affect the auditor's opinion

HKSA 705.7, 8, 9, 10

Key terms

A **qualified opinion** is expressed when:

(a) the auditor, having obtained sufficient appropriate audit evidence, concludes that **misstatements**, individually or in the aggregate, are material, but not pervasive, to the financial statements

(b) the auditor is **unable to obtain sufficient appropriate audit evidence** on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

A **disclaimer of opinion** is expressed when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor must also disclaim an opinion where, in rare cases the auditor is not able to form an opinion on the financial statements due to the potential interaction of multiple uncertainties and their possible cumulative effects.

An **adverse opinion** must be expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that **misstatements**, individually or in the aggregate, are both **material and pervasive** to the financial statements.

Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects are those that in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures are fundamental to users' understanding of the financial statements.

HKSA 705.11-14

HKSA 700 (Clarified) requires that the auditor shall modify the opinion in the auditor's report in accordance with HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report* when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be **material** to the financial statements:

(a) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (this is also referred to as a limitation on scope)

(b) The auditor concludes that, based on the audit evidence obtained the financial statements as a whole are not free from material misstatement

The following table summarises the different types of modified opinion and we will look at the detail of each of these in turn:

Qualification matrix

Nature of circumstances	Material but not pervasive	Material and pervasive
Inability to obtain sufficient appropriate evidence	**Qualified opinion** (auditors disclaim an opinion on a particular aspect of the accounts which is not considered fundamental)	**Disclaimer of opinion** (auditors state they are unable to form an opinion on truth and fairness)
Financial statements are materially misstated	**Qualified opinion** (auditors express an adverse opinion on a particular aspect of the financial statements which is not considered fundamental)	**Adverse opinion** (auditors state that the financial statements do not give a true and fair view)

Where the opinion is modified a Basis for Modification paragraph is included (see Section 3.3.1).

Nature of material misstatements

HKSA 700 (Clarified) requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. This conclusion takes into account the auditor's **evaluation of uncorrected misstatements**, if any, on the financial statements in accordance with HKSA 450 (Clarified).

HKSA 450 (Clarified) defines a misstatement as a difference between the **amount, classification, presentation, or disclosure** of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to:

(a) the appropriateness of the selected accounting policies;
(b) the application of the selected accounting policies; or
(c) the appropriateness or adequacy of disclosures in the financial statements.

3.2.1 Inability to obtain sufficient appropriate audit evidence

When the auditor has not accumulated sufficient appropriate evidence to determine if financial statements are stated in accordance with acceptable accounting policies, not through his own fault, a limitation on scope exists.

There are two circumstances identified by the standard where there might be a limitation on scope.

(a) **Limitation on the scope of audit imposed by management**

First, a limitation on the scope of the auditor's work may sometimes be **imposed by the management** (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary).

Examples of limitation by management:

- Management prevents the auditor from observing the counting of the physical inventory.

- Management prevents the auditor from requesting external confirmation of specific account balances.

The auditor shall **request that management remove the limitation**. If management refuses to remove the limitation, the auditor shall communicate the matter to **those charged with governance involved in managing the entity** and determine whether it is possible to perform **alternative procedures** to obtain sufficient appropriate audit evidence.

However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would usually not accept such a limited audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

If the auditor has **substantially completed the audit**, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation in the Basis for Disclaimer of Opinion paragraph prior to withdrawing.

If the auditor **withdraws** from the engagement, before doing so he shall **communicate to those charged with governance** any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. There may also be a **professional, legal or regulatory requirement** for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

(b) **Limitation on the scope of audit where circumstances are beyond the control of the entity or circumstances relate to the nature or timing of the auditor's work**

Second, a scope limitation may be **imposed by circumstances** (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventory). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out **reasonable alternative procedures** to obtain sufficient, appropriate audit evidence to support an unmodified opinion.

Examples of such limitations:

Circumstances beyond the control of the entity	Circumstances relating to the nature or timing of the auditor's work
The entity's accounting records have been destroyed. The accounting records of a significant component have been seized indefinitely by governmental authorities.	The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied. The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories (ie auditor appointed after year end). The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

The auditor's report should describe the **limitation and indicate the possible adjustments** to the financial statements that might have been determined to be necessary had the limitation not existed.

The following examples are reports given as a result of an inability to obtain sufficient appropriate evidence.

Qualified Opinion

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

Report on the Financial Statements

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position] as at 31 December 201X, and the [statement of profit or loss][statement of profit or loss and other comprehensive income], statement of changes in equity and [cash flow statement][statement of cash flows] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit 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. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for **our qualified audit opinion**.

Basis for Qualified Opinion

ABC Limited's investment in DEF Limited, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the [balance sheet][statement of financial position] as at 31 December 201X, and ABC's share of DEF's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in DEF as at 31 December 201X and ABC's share of DEF's net income for the year because we were denied access to the financial information, management, and the auditors of DEF. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, **except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph,** the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 201X, and of its [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Report on matters under sections 141(4) and 141(6) of the Hong Kong Companies Ordinance

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate:

- We have not obtained all the information and explanations that we considered necessary for the purpose of our audit and
- We were unable to determine whether proper books of account had been kept.

Disclaimer of opinion

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

Report on the Financial Statements

We were engaged to audit the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position] as at 31 December 201X, and the [statement of profit or loss][statement of profit or loss and other comprehensive income], statement of changes in equity and [cash flow statement][statement of cash flows] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the inability to obtain sufficient appropriate audit evidence as explained below, we conducted our audit 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 as to whether the financial statements are free from material misstatement. **Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.**

Basis for Disclaimer of Opinion

The Company's investment in its joint venture DEF (Country X) Limited is carried at xxx on the Company's [balance sheet][statement of financial position] which represents over 90% of the Company's net assets as at 31 December 201X. We were not allowed access to the management and the auditors of DEF, including DEF's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Company's proportional share of DEF's assets that it controls jointly, its proportional share of DEF's liabilities for which it is jointly responsible, its proportional share of DEF's income and expenses for the year, and the elements making up the statement of changes in equity and [cash flow statement][statement of cash flows].

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, **we have not been able** to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Report on matters under sections 141(4) and 141(6) of the Hong Kong Companies Ordinance

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate:

- We have not obtained all the information and explanations that we considered necessary for the purpose of our audit and
- We were unable to determine whether proper books of account had been kept.

3.2.2 Nature of material misstatement

The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. The HKSA states that if such disagreements are material to the financial statements, the auditor should express a modified opinion.

Circumstances giving rise to such material misstatements include the following:

Departure from **acceptable accounting practices** where there has been a failure to comply with Accounting Standards and the auditor does not concur (ie financial statements are not prepared in accordance with HKAS). Misstatements could arise due to the following.

- **Inappropriateness of the selected accounting policies**

  In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise when

  (i) the selected accounting policies are not consistent with the applicable financial reporting framework; or

  (ii) the financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation.

  Examples include:

  – when entity uses replacement costs for permanent assets

  – when entity uses the cash basis of accounting instead of the accruals basis of accounting

  – accounting principles used in the financial statements have not been consistently applied (eg switch from FIFO to Weighted Average method in valuing inventory)

- **Misapplication of the selected accounting policies**

  In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

  (i) when **management has not applied the selected accounting policies consistently** with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or

  (ii) due to the method of application of the selected accounting policies (such as an unintentional error in application).

- **Inappropriateness or inadequacy of disclosures in the financial statements**

  In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

  (i) the financial statements do not include all of the disclosures required by the applicable financial reporting framework;

  (ii) the disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or

  (iii) the financial statements do not provide the disclosures necessary to achieve fair presentation.

The following examples are reports given as a result of a material misstatement.

Qualified Opinion

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

[Report on the Financial Statements]

We have audited the financial statements of ABC Limited (the "Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position] as at 31 December 201X, and the [statement of profit or loss][statement of profit or loss and other comprehensive income], statement of changes in equity and [cash flow statement][statement of cash flows] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation[4] of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit 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. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

The Company's inventories are carried in the [balance sheet][statement of financial position] at xxx. The directors have not stated the inventories at the lower of cost and net realisable value but have stated them solely at cost, which constitutes a departure from Hong Kong Financial Reporting Standards. The Company's records indicate that had the directors stated the inventories at the lower of cost and net realisable value, an amount of xxx would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

Qualified Opinion

In our opinion, **except for the effects of the matter described in the Basis for Qualified Opinion paragraph,** the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 201X, and of its [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Adverse opinion

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)

[Report on the Consolidated Financial Statements]

We have audited the consolidated financial statements of ABC Limited (the "Company") and its subsidiaries (together —the Group) set out on pages …… to ……, which comprise the consolidated and company [balance sheets][statements of financial position] as at 31 December 201X, and the consolidated [statement of profit or loss][statement of profit or loss and other comprehensive income], the consolidated statement of changes in equity and the consolidated [cash flow statement][statement of cash flows] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Consolidated Financial Statements

The directors of the Company are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit 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 consolidated financial statements are free from material misstatement.
An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of consolidated financial statements that give a true and fair view 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion

As explained in Note X, the Company has not consolidated the financial statements of subsidiary DEF Limited it acquired during 201X because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under Hong Kong Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the Company. Had DEF been consolidated, many elements in the financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, **because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph**, the consolidated financial statements **do not give a true and fair view** of the state of affairs of the Company and of the Group as at 31 December 201X, and of the Group's [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the consolidated financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.

3.3 Form and content of the auditor's report when the opinion is modified

3.3.1 Basis for modification opinion

HKSA 705.16-21

The auditor shall **add a paragraph immediately before the opinion paragraph** in addition to the specific elements required by HKSA 700 (Clarified) in the auditor's report and use the heading "Basis for Qualified Opinion", "Basis for Adverse Opinion", or "Basis for Disclaimer of Opinion", as appropriate when the auditor decides to modify the opinion on the financial statements. This paragraph provides a **description of the matter** giving rise to the modification.

3.3.2 Quantitative disclosures

The auditor shall include in the basis for modification paragraph a description and **quantification of the financial effects** of the material misstatement that relates to specific amounts in the financial statements. The auditor must state in the basis for modification when quantification of the financial effects is impracticable.

3.3.3 Narrative disclosures and non-disclosure of information

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

(a) discuss the non-disclosure with those charged with governance

(b) state in the basis for modification paragraph

(c) unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information

If there is any inability to collect sufficient and appropriate audit evidence, the auditor shall include in the basis for modification paragraph the reasons for that inability.

HKSA 705.22-25

3.3.4 Opinion paragraph

(a) **Heading**

The auditor shall use the heading "Qualified Opinion", "Adverse Opinion", or "Disclaimer of Opinion", as appropriate, for the opinion paragraph for modification of opinion.

(b) **Qualified opinion: material misstatement**

For material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, **except for** the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

(i) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework.

(ii) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

(c) **Qualified opinion: inability to obtain sufficient appropriate evidence**

The auditor must use the corresponding phrase ..'**except for** the possible effects of the matters…'

The auditor shall include in the basis for modification paragraph the reasons for that inability to obtain sufficient appropriate audit evidence.

(d) **Adverse opinion**

The auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the **significance** of the matter(s) described in the Basis for Adverse Opinion paragraph:

(i) The financial statements **do not present fairly** (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework.

(ii) The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

HKSA 705 (Clarified) requires that when auditor considers it necessary to express an adverse opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement.

To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion on the financial statements as a whole.

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified opinion.

(e) **Disclaimer of opinion**

When the auditor **disclaims an opinion** due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

(i) Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor **has not been able to obtain sufficient appropriate audit evidence** to provide a basis for an audit opinion; and, accordingly

(ii) The auditor **does not express** an opinion on the financial statements.

HKSA 705 (Clarified) requires that when the auditor considers it necessary to disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement as this would create contradiction.

The auditor shall **amend** the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following: "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with Hong Kong Standards on Auditing. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

Self-test question 1

You are the audit manager of a CPA firm and are responsible for the audit of DEF Limited ("DEF") for the year ended 30 April 20X0.

DEF engages in the trading of household electrical products and is a private company owned by ten families with equal shareholdings. Half of these shareholders have no representation in DEF's board of directors. In September 20X9, DEF acquired 70% of the equity interest of GHI Limited ("GHI"), an enterprise incorporated in the Mainland of China manufacturing household accessories with a year-end at 31 December.

The financial statements of GHI for the year ended 31 December 20W9 have been audited by your firm's affiliate in the Mainland of China. You have conducted a peer review of this affiliate and were satisfied with its level of competence. GHI has a revenue of RMB93 million and made an operating loss of RMB 3.9 million for the year ended 31 December 20W9. Its net assets as at that date amounted to RMB 19 million.

For the year ended 30 April 20X0, DEF's revenue dropped by 20% to HK$180 million, Its pre-tax profit also dropped by 13% to HK$8 million. Its net assets as at 30 April 20X0 amounted to HK$23 million. Materiality level for adjustment was set at 1% of ABC's net equity.

Prior to your finalising the audit, the following events occurred:

Event 1

DEF's directors suddenly decided to exclude GHI from consolidation. In their opinion, it was considered impracticable to consolidate GHI because its operations were substantially different from those of DEF. Accordingly, you were requested by DEF's director to stop performing any further audit work on GHI for the purpose of consolidating GHI into DEF's group accounts. In order to comply with the statutory requirements of the Companies Ordinance, DEF's directors proposed that the group accounts laid before the members at a general meeting consist of separate audited financial statements dealing with DEF and GHI. All necessary information required by law about the results of GHI and the extent to which they have been dealt with in DEF's accounts would be fully disclosed in DEF's financial statements by way of notes.

Event 2

On 28 May 20X0, a substantial customer of DEF went bankrupt after suffering unexpected losses from a major lawsuit. This customer accounted for roughly 12% of DEF's total revenue and had an outstanding debit balance approximately HK$1.1 million at 30 April 20X0. The provisional liquidator of this customer indicated that the chance of the creditors in recovering their debts would be very slim. The directors of DEF, without any valid justification, agreed only to make an 80% allowance for this balance in their accounts.

Required

Write a memorandum to your audit partner addressing each of the events described above. Suggest the appropriate type of audit report to be issued, giving reasons for your suggestions.

Assume that DEF's directors are adamant about the treatments outlined and that you encounter no major audit issues other than those described.

(a) Event 1

(b) Event 2

(The answer is at the end of the chapter)

Self-test question 2

During the audit of XZY Pty Limited (XZY) you noted the following independent items:

(a) XZY has made an allowance of HK$250,000 for irrecoverable receivables. Based on your audit work, you are of the opinion that a provision of HK$450,000 should be made instead.

(b) Total cash balance at the reporting date was HK$740,000, kept in several bank accounts of XZY. Some of these bank accounts are in a foreign country. The amount of cash kept in the accounts maintained in the foreign country was HK$528,750. You have been unable to obtain bank audit confirmations or any other third party confirmations with respect to the foreign bank accounts.

The entity has been unable to supply you with bank statements or other supporting documentation in relation to these bank accounts.

All cash balances are classified as current assets in the entity's financial statements.

(c) XZY is highly computerised and would be unable to transact business in the event of a prolonged computer failure. Your audit reveals no back-up and recovery procedures, no contingency plans, and no business interruption insurance in the case of such an event.

You are unsure how to proceed and have just gone to see the audit manager for advice.

Required

The audit manager is happy to assist you, but first he wants to hear, for each of the items independently:

- What you would do prior to issuing the auditor's report
- The type of report you would issue and why.

(The answer is at the end of the chapter)

3.4 Communication with those charged with governance

HKSA 705.28

Communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the proposed wording of the modification enables the following:

(a) The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);

(b) The auditor to seek the concurrence of those charged with governance regarding the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and

(c) Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

4 Emphasis of matter and other matter paragraphs

Topic highlights

An **emphasis of matter paragraph** is used by the auditor to **highlight** an issue affecting the financial statements which the readers should know about but which does not give rise to a modified opinion.

HKSA 706.5

Key terms

Emphasis of matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

Other matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

4.1 Emphasis of matter

HKSA 706.6, 7, Appendix 1, Appendix 3

Under HKSA 706 (Clarified) if the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. This paragraph must only refer to information presented or disclosed in the financial statements.

The auditor shall:

(a) include the emphasis of matter immediately after the Opinion paragraph in the auditor's report

(b) use the heading "Emphasis of Matter", or other appropriate heading

(c) include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements

(d) indicate that the auditor's opinion is not modified in respect of the matter emphasised

There are various **examples** of circumstances where the auditor may consider it necessary to include an emphasis of matter paragraph:

(a) An **uncertainty** relating to the **future outcome** of exceptional litigation or regulatory action

(b) **Early application** (where permitted) of a new accounting standard (for example, a new Hong Kong Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date

(c) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position

Inherent uncertainty

In certain circumstances, an auditor's report may include a paragraph to highlight a material matter regarding a **going concern problem** or if there is a **significant uncertainty**, the resolution of which is dependent upon future events and which may affect the financial statements and not under the direct control of the entity.

The circumstances include those listed below:

(a) **Additional disclosures** with which the auditor concurs

The disclosures in accordance with accounting standards could be potentially misleading but these disclosures are necessary and it is in line with the objectives of a general purpose financial report.

(b) **Inherent uncertainty** (including going concern) that is adequately disclosed

Outcome of item or disclosure contingent upon future events that is not susceptible to reasonable estimates prior to the issue of the auditor's report, for example, going concern, lawsuit.

Inherent uncertainty with adequate disclosure – **Unqualified opinion**

Inherent uncertainty with **inadequate disclosure** – This constitutes a material misstatement and therefore an "except for" or adverse opinion is to be given (see below).

Certain HKSAs contain specific requirements for an emphasis of matter paragraph. These include:

HKSA 210 (Clarified) ***Agreeing the Terms of Audit Engagements***	The auditor shall draw users' attention to the additional disclosures in the financial statements that is required to avoid the financial statements being misleading when the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable.
HKSA 560 (Clarified) ***Subsequent Events***	If, after the financial statements have been issued a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, and if management amends the financial statements, the auditor shall include in the new auditor's report an emphasis of matter paragraph or other matter paragraph referring to a note to the financial statements that more extensively discusses the reason for amendment.
HKSA 570 (Clarified) ***Going Concern***	If the auditor concludes that a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern, but the use of the going concern assumption is appropriate in the circumstances and adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an emphasis of matter paragraph in the auditor's report to highlight the existence of a material uncertainty and draw attention to the note in the financial statements.

Sample wording:

Example 1: uncertainty relating to pending exceptional litigation matter

Emphasis of matter

We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the Company by DEF Company. Our opinion is not qualified in respect of this matter.

Example 2: going concern issue

Emphasis of matter

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 201X and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with the matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

4.2 Other matter paragraph

HKSA 706.8, A5-A8

When an other matter paragraph is included to **draw users' attention** to a matter relevant to their understanding of the audit of the financial statements but which is not presented or disclosed in the financial statements, the paragraph is included immediately after the opinion paragraph and any emphasis of matter paragraph.

Circumstances in which an other matter paragraph may be necessary:

(a) When the auditor is **unable to withdraw from an engagement** even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive, the auditor may consider including an other matter paragraph in the auditor's report to explain the fact.

(b) The auditor can elaborate matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon under law, regulation or generally accepted practice in a jurisdiction.

(c) An entity may engage the auditor to report on both sets of financial statements under two general purpose frameworks (ie Hong Kong Financial Reporting Standards and the International Financial Reporting Standards).

The auditor may include an other matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with **another general purpose framework** and that the auditor has issued a report on those financial statements.

(d) When the auditor's report is **intended for specific users**, the auditor may consider it necessary to include an other matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

Self-test question 3

You are the audit manager of Jackson CPA firm. You are responsible for the audits of the financial statements of a new entity, Kristy Jewellery (Kristy), for the year ended 31 December 20Y0.

The auditors of Kristy's financial statements for the year ended 31 December 20X9 have included an emphasis of matter paragraph on the material uncertainty in respect of Kristy's ability to continue as a going concern. Your assistant has suggested to you that this will not affect the audit work for the current year since the issue did not affect the reliability of individual items of information reported in the audited financial statements for the year ended 31 December 20X9.

Required

Do you agree with your audit assistant's view about the emphasis of matter paragraph in the auditors' report for Kristy's financial statements for the year ended 31 December 20Y0 with regard to Kristy's going concern? Explain your views.

(The answer is at the end of the chapter)

4.3 Summary

We summarise here the relevant HKSAs that contain requirements relating to emphasis of matter and other matter paragraphs.

List of HKSAs containing requirements for emphasis of matter paragraphs	List of HKSAs containing requirements for other matter paragraphs
HKSA 210 (Clarified) *Agreeing the Terms of Audit Engagements* HKSA 560 (Clarified) *Subsequent Events* HKSA 570 (Clarified) *Going Concern* HKSA 800 (Clarified) *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*	HKSA 560 (Clarified) *Subsequent Events* HKSA 710 (Clarified) *Comparative Information – Corresponding Figures and Comparative Financial Statements* HKSA 720 (Clarified) *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

5 Special considerations – audit of financial statements prepared in accordance with special purpose frameworks

Topic highlights

HKSA 800 (Clarified) deals with special considerations: the audit of financial statements prepared in accordance with special purpose frameworks.

HKSA 800 (Clarified) *Special Considerations – Audit of Financial Statements Prepared in Accordance with Special Purpose Framework* deals with special considerations in the application of those HKSAs to an audit of financial statements prepared in accordance with a special purpose framework. The standard is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Key terms

HKSA 800.6

Special purpose financial statements – Financial statements prepared in accordance with a special purpose framework other than a general purpose framework.

Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

Examples of special purpose frameworks:

(a) A tax basis of accounting for a set of financial statements that accompany an entity's tax return

(b) The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors

(c) The financial reporting provisions established by a regulator to meet the requirements of that regulator

(d) The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant

5.1 Factors when accepting the engagement

HKSA 800.8

In an audit of special purpose financial statements, the auditor shall obtain an understanding of:

(a) the purpose for which the financial statements are prepared

(b) the intended users

(c) the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances

5.2 Considerations when planning and performing the audit

HKSA 800.9-10

In planning and performing an audit of special purpose financial statements, the auditor shall determine whether application of the HKSAs requires special consideration in the circumstances of the engagement.

In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.

5.3 Forming an opinion

HKSA 800.11, Appendix

When forming and reporting on special purpose financial statements, the auditor shall apply the requirements in HKSA 700 (Clarified).

In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information.

The following is an extract to show that the financial statements have been prepared by management of the entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework) to comply with the provisions of that contract.

(Appropriate Addressee)

We have audited the financial statements of ABC Limited…..

The financial statements have been prepared by management of the Company based on the financial reporting provisions of Section 2 of the contract dated 1 January 201X between the Company and DEF Company ("the contract").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the financial reporting provisions of Section Z of the contract, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Opinion

In our opinion the financial statements of the Company for the year ended 31 December 201X are prepared, in all material respects, in accordance with the financial reporting provisions of Section Z of the contract.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to comply with the financial reporting provisions of the contracts referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Company and DEF Company and should not be distributed to or used by parties other than the Company or DEF Company.

The following is an alternative illustration to demonstrate that the financial statements have been prepared by management of a partnership in accordance with the tax basis of accounting in Jurisdiction X (that is, a special purpose framework) to assist the partners in preparing their individual income tax returns. Management does not have a choice of financial reporting frameworks.

(Appropriate Addressee)

We have audited the financial statements of ABC Partnership ("the Partnership")…..

The financial statements have been prepared by management using the tax basis of accounting in Jurisdiction X.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the tax basis of accounting in Jurisdiction X, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Opinion

In our opinion, the financial statements of the Partnership for the year ended 31 December 201X are prepared, in all material respects, in accordance with (describe the applicable income tax law) of Jurisdiction X.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the partners of the Partnership in preparing their individual income tax returns. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Partnership and its partners and should not be distributed to parties other than the Partnership or its partners.

6 Special considerations – audits of single financial statements and specific elements, accounts or items

Topic highlights

HKSA 805 (Clarified) deals with special considerations – audits of single financial statements and specific elements, accounts or items of a financial statement.

HKSA 805 (Clarified) *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* is an auditing standard that deals with special considerations in the application of those HKSAs to an **audit of a single financial statement or of a specific element**, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework where HKSA 800 (Clarified) would also apply.

HKSA 805.6

Key terms

"**Element of financial statement**" or "**element**" means an "element, account or item of a financial statement".

A single financial statement or a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

This HKSA does not apply to the report of a component auditor when a group audit is involved. This HKSA is effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after 15 December 2009.

In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements.

6.1 Factors when accepting the engagement

6.1.1 Application of HKSAs

HKSA 805.7-9

If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with all HKSAs is practicable.

6.1.2 Acceptability of the financial reporting framework

In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include consideration or whether **application of the financial reporting framework (HKSA 210 (Clarified))** will result in a presentation that provides **adequate disclosures** to enable the intended users to understand the information conveyed in the financial statement or the element. It will also require consideration of the effect of material transactions and events on the information conveyed in the financial statement or the element.

6.1.3 Form of opinion

In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances.

6.2 Considerations when planning and performing the audit

HKSA 805.10

In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all HKSAs relevant to the audit as necessary in the circumstances of the engagement.

6.3 Forming an opinion

HKSA 805.11, 14-16

HKSA 700 (Clarified) shall be applied when forming an opinion and reporting on a single financial statement or on a specific element of a financial statement. If the auditor is also auditing the entity's complete set of financial statements, he shall express a separate opinion for each engagement. An audited single financial statement or an audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements.

6.3.1 Emphasis of matter paragraph

If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an emphasis of matter paragraph or an other matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements.

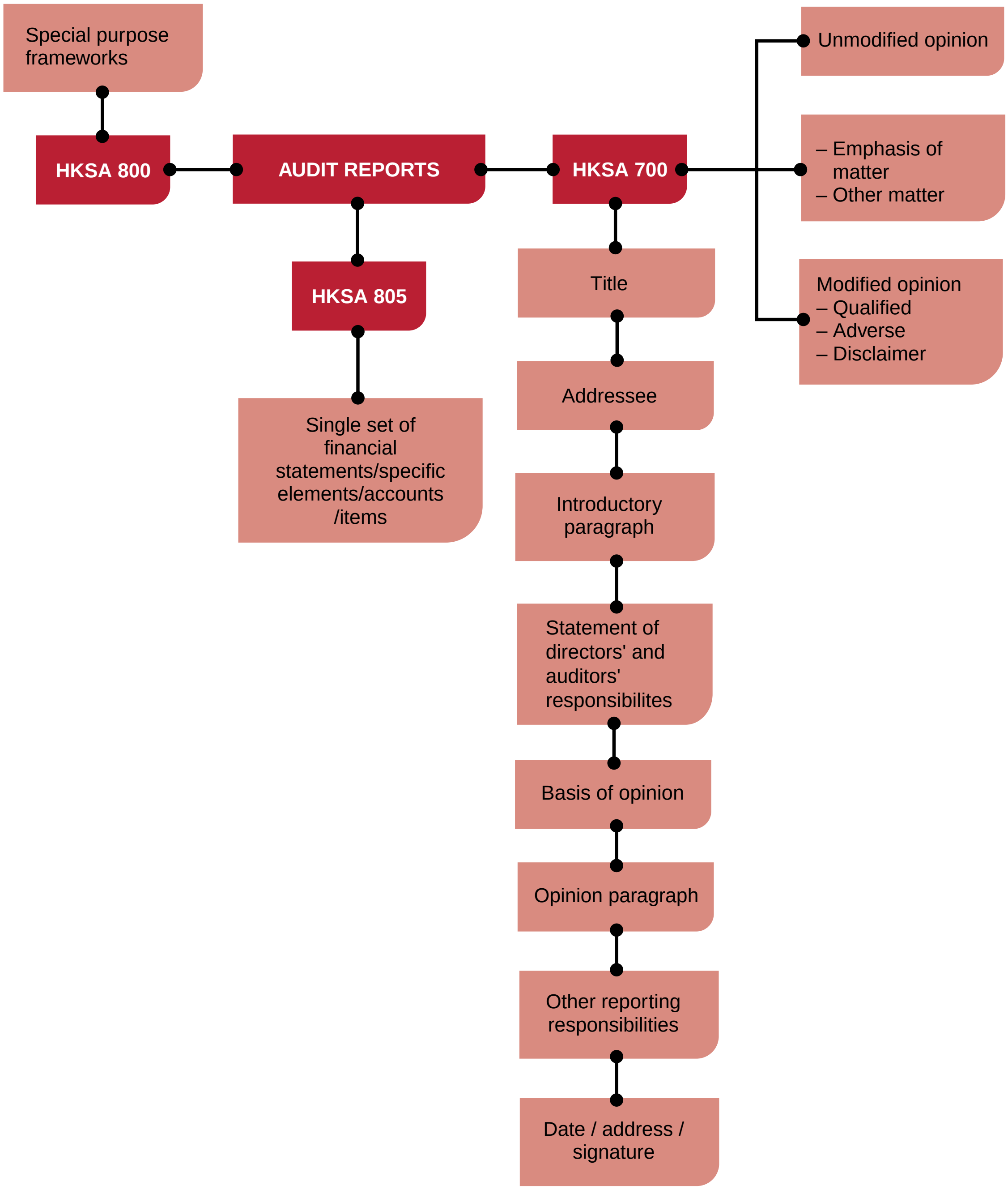
The auditor shall modify the opinion on the single financial statement or on the specific element of a financial statement, or include an emphasis of matter paragraph or an other matter paragraph in the auditor's report where appropriate.

6.3.2 Adverse opinion or disclaimer of opinion

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, HKSA 705 (Clarified) does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element that forms part of those financial statements.

This is the case even if the auditor's report on the single financial statement is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion.

Topic recap


Special purpose frameworks
HKSA 800
AUDIT REPORTS
HKSA 805
Single set of financial statements/specific elements/accounts /items
HKSA 700
Title
Addressee
Introductory paragraph
Statement of directors' and auditors' responsibilites
Basis of opinion
Opinion paragraph
Other reporting responsibilities
Date / address / signature
Unmodified opinion
– Emphasis of matter
– Other matter
Modified opinion
– Qualified
– Adverse
– Disclaimer

Answers to self-test questions

Answer 1

DEF Limited

I have performed a review of the audit work papers for DEF and would like to draw your attention to the following issues:

Event 1

Exclusion of GHI from Consolidation

DEF directors decided to exclude GHI from consolidation on the grounds that GHI's operations were substantially different from DEF's. They proposed DEF's group accounts to be laid before the members at the forthcoming general meeting would consist of separate accounts dealing with the company and the subsidiary, with all necessary information required by law fully disclosed in DEF's financial statements. Although such treatment is permitted under the Companies Ordinance, it is a departure from the requirements stipulated in HKFRS 10 which require a parent to present consolidated financial statements.

The grounds that GHI's business activities are dissimilar from DEF's are not considered by HKFRS 10 as a good reason for exclusion from consolidation. Indeed, although DEF is unlisted and therefore need not comply with the requirement of HKFRS 8, adequate disclosure made according to the framework of HKFRS 8 would definitely help to explain to readers the significance of the different business activities within the group.

Since the difference between reporting dates of DEF and GHI is more than three months, it is not possible to use the audited financial statements of GHI for consolidation pursuant to HKFRS 10. In addition, as we are unable to ascertain the financial position of GHI at 30 April 20X0, we are not in a position to express an opinion about the disclosed operating results and financial positions of the group.

In view of the above, I consider multiple qualifications to our audit report necessary. These would include a material misstatement due to the departure from HKFRS 10 and a material misstatement due to the use of financial statements of a different year end date with a time gap of more than three months, and a disclaimer of the group results and financial position so presented.

Event 2

Bankruptcy of a substantial customer subsequent to the year-end

The bankruptcy of a debtor after the year-end provides additional evidence of conditions existing at the end of the reporting period. Accordingly it is an adjusting event pursuant to HKAS 10, since the possibility of recovering the outstanding debt is very slim, and full allowance for irrecoverable receivables' on such receivables needs to be made.

Since DEF's directors refuse to change the provision from 80% to 100%, there is a disagreement with management. The difference of HK$0.22 million between the two provisions represents approximately 0.95% of DEF's net equity. As this difference is lower than the materiality level set for this audit, it is considered immaterial for adjustment. I therefore recommend that the audit opinion should not be modified in this respect.

Answer 2

(a) The following factors need to be considered:

(i) Whether your estimate of the provision of impairment loss of HK$450,000 is a more appropriate estimate than the management's estimate.

(ii) Whether the amount of under-provision of HK$200,000 is material.

(iii) The entity's opinion of your assessment of the provision of HK$450,000. There may be circumstances that would change your judgment, that is, ensure that you and your entity are aware of the same information in making the judgment on the appropriate amount of provision.

(iv) Review prior year financial statements for any prior year qualification; and explain to the entity what any qualification of the auditor's report would entail.

Assuming that, after the above considerations, you are still of the opinion that there is an underprovision of HK$200,000 in the allowance for irrecoverable receivables, an "except for" qualification on the grounds of material misstatement should be issued. Although the issue may be material, it would probably be unlikely that the financial statements are seriously misleading and therefore an adverse opinion should be unlikely.

(b) The following factors need to be considered:

(i) Are there any alternative procedures to obtain evidence regarding the assertions of the existence and rights and obligations of the cash balance?

(ii) Whether the amount of HK$528,750 is material

(iii) Why bank audit confirmations, third party confirmations or bank statements, or other supporting in relation to the bank balance are not available

(iv) Whether there was a prior year qualification (also review the account to see if there has been any movement in the balance during the year)

The audit opinion will depend on the precise circumstances. If the assertions of the existence and the rights and obligations of the HK$528,750 bank account balances cannot be verified due to a limitation on the ability of the auditor to obtain sufficient appropriate evidence, an "except for" qualification on the grounds of this limitation on scope should be issued if the matter is material. Alternatively, if XZY cannot present any documentary support of the bank balances, and it is not unreasonable to conclude that XZY cannot enforce its claims over the "bank balances" should not be recognised as an asset in the financial statements. If the effect is so material or pervasive that the financial statements are seriously misleading, an adverse opinion should be issued.

(c) The following factors need to be considered:

(i) What the effects of a prolonged computer failure will be

(ii) Whether a prolonged computer failure and loss of computer data will have material effect on the going concern of the entity

(iii) If it is reasonable to conclude that a prolonged computer failure and loss of computer data will cause a significant level of concern about the validity of the going concern basis, for example, the entity will no longer be able to collect debts from customers.

Due to loss of data or significant claims for losses by outside parties due to failure of the computer operation, the matter should be dealt with in accordance with HKSA 570 (Clarified) *Going Concern*.

Answer 3

Possible existence of going concern indicators in the current year

The emphasis of matter highlighted the existence of a fundamental uncertainty relating to the event or condition that may cast significant doubt on Kristy's ability to continue as a going concern.

Since this material uncertainty may continue to exist in the current year, we need to assess how such uncertainty may affect our audit work and reporting.

In planning our audit of Kristy's financial statements for the year ended 31 December 20Y0, we should assess whether any of the events or conditions that may cast significant doubt on the going concern of Kristy ("going concern indicators") mentioned by Kristy's previous auditors continue to exist.

During the course of our audit, we should also be alert to other going concern indicators not mentioned by Kristy's previous auditors.

Audit work if going concern indicators exist

If these going concern indicators continue or new indicators are identified, we should

(a) consider whether they affect our assessments of the components of audit risk

(b) review management plan of Kristy for future actions based on its going concern assessment

(c) gather sufficient appropriate audit evidence to confirm or dispel the notion that a fundamental uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors

(d) seek written representations from Kristy's management regarding its plans for future action.

Exam practice

QQ Laundry Ltd — 25 minutes

QQ Laundry Ltd has ten shops in Hong Kong. One of the shops has been making a loss because of its poor location. The non-current assets of the loss-making shop mainly comprise commercial washing machines and dryers and are stated at $500,000 (after a write-down for impairment loss of $100,000) in the draft financial statements. The auditors consider that the reported value of the assets ($500,000) is material to the financial statements of QQ Laundry Ltd.

There is a brand new residential estate close to the loss-making shop, and residents have recently started moving in. Accordingly, business has improved slightly, and the management of QQ Laundry Ltd expect to see the shop turning profitable during the new financial year. According to the management, the value of the assets to the business would be greater than $500,000 when the shop is profitable.

All relevant audit evidence suggests that the shop is to close if its business does not improve significantly. If the shop closes, its assets would be worth nothing because the cost of moving them to other shops would exceed their net realisable value.

Required

State whether or not the audit report should be qualified and explain the most appropriate type of qualification (if applicable) in each of the two following situations:

(a) The auditors agree with the management's assessment of the uncertainty over the non-current assets at the loss-making shop; and **(7 marks)**

(b) The auditors disagree with the management's assessment and are convinced that losses will continue, leading to closure of the loss-making shop and requiring the complete write-off of the assets. **(7 marks)**

(Total = 14 marks)

HKICPA February 2006

Part E

Other audit matters

This Part discusses the management aspect of an assurance process, eg a group audit situation, and other assurance engagements. It will also embrace any issues not covered in the basic context.

chapter 18

Group audits

Topic list

Learning focus

HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* is effective for audits of financial statements for periods beginning on or after 15 December 2009. This HKSA deals with special considerations that apply to group audits, especially when those involve component auditors.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	**Audit procedures**	3
2.09.11	Recognise and explain the issues relating to the audit of a group of companies	
2.12	**Completion procedures**	3
2.12.01	Explain the purpose of and the procedures to be used in:	
2.12.01.04	Review of report by other auditors to principal auditors of a group of companies	

1 Audit of groups

Topic highlights

Auditing a group of companies adds another level of complexity to an audit assignment, as the auditor has to consider issues that relate to the individual companies and also the group as a whole. Key procedures such as the assessment of audit risk and the assignment of materiality have to be approached in a different way.

The applicable regulatory and financial reporting framework for a group in Hong Kong is the Companies Ordinance and HKFRSs.

If a holding company and its subsidiary are incorporated in Hong Kong, s. 133(1)(a) of the Companies Ordinance imposes a duty on the subsidiary and its auditors to give to the auditors of the holding company such information and explanation as those auditors may reasonably require for the purposes of their duties as auditors of the holding company.

Where a holding company is incorporated in Hong Kong, but its subsidiary is not, s. 133(1)(b) of the Companies Ordinance imposes a duty on the holding company, if required by its auditors to do so, to take all such steps as are reasonably open to it to obtain from the subsidiary such information and explanation as the group engagement team may reasonably require for the purpose of their duty as the group engagement team.

Under the new Hong Kong Companies Ordinance

The new Companies Ordinance ("the new CO") enhances the rights of auditors. Pursuant to s. 412 of the new CO, auditors may require information and explanation for the performance of their duties from a wider range of persons, including persons holding or accountable for any accounting records of the company or a Hong Kong incorporated subsidiary of the company.

It also empowers auditors to require the company to obtain information and explanation for the performance of their duties from persons holding or accountable for the accounting records of a **non-Hong Kong incorporated subsidiary.**

The **persons** who will be required to provide information or explanation to auditors pursuant to s. 412 of the new CO are:

(a) an officer of the company;

(b) a Hong Kong subsidiary of the company;

(c) an officer or auditor of such a subsidiary;

(d) a person holding or accountable for any of the accounting records of the company or such a subsidiary; or

(e) any of the above persons or subsidiary at the time to which the information or explanation relates.

The auditor of a holding company may also require the company to obtain information or explanation from its non-Hong Kong subsidiary, the officers and auditor of such a subsidiary and persons holding or accountable for any of the accounting records of such a subsidiary.

A person who **fails** to provide the required information or explanation commits an offence and is liable to a fine **not exceeding $25,000** and, in the case of a continuing offence, a daily fine **not exceeding $700**. It is a defence to establish that it was not reasonably practicable for the person to provide the information or explanation.

If a company **fails** to take reasonable steps to obtain the required information or explanation in respect of its non-Hong Kong subsidiary, the company and every responsible person of the company commits an offence and each is liable to a fine **not exceeding $25,000** and, in the case of a continuing offence, a daily fine **not exceeding $700**. It is a defence for the holding company's failure to obtain the information or explanation in respect of its non-Hong Kong subsidiary if it would be an offence under the law of the relevant jurisdiction for the subsidiary to provide the information or explanation.

HKSA 600.9

Key terms

Group engagement team – Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group engagement partner – The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Significant component – A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

1.1 Significant components

HKSA 600.A5-A6

It is important to consider whether the component is a significant component or not. The following factors should be considered for determining a significant component:

(a) Individually significant component:

The risks of material misstatement of the group financial statements would **increase** when the individual financial significance of a component increases. The group engagement team, using professional judgment, may **identify a benchmark** and determine a **percentage** to be applied to identify which are significant components. Depending on the nature of the group, benchmarks might include group assets, revenue or profit.

(b) Component likely to include **significant risks** of material misstatement of the group financial statements

The group engagement team may identify a component that is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances.

1.2 Group-wide controls

HKSA 600.9

Key term

Group-wide controls are controls designed, implemented and maintained by group management over group financial reporting.

Some of the examples of group-wide controls include the following:

(a) **Regular meetings** – meeting between group and component management to discuss the business development and review of performance

(b) **Monitoring controls** – monitoring components' operations and financial results

(c) **Group management's risk assessment process** – process identifying, analysing and managing business risks for the group

(d) **Intra-group transactions** – monitoring, controlling, reconciling and eliminating intra-group transactions and unrealised profits

(e) **Components' financial information** – monitoring process of the timeliness and assess the accuracy and completeness of these financial information

(f) **IT controls** – a central IT system controlling all general IT controls for all or part of the group and control activities within an IT system applying for all or some components

(g) **Monitoring controls** – internal audit and self assessment programmes applied to the group

(h) **Group financial reporting procedures manual** – consistent policies and procedures applied to the group

(i) **Group-wide programmes –** Codes of conduct and fraud prevention programmes

(j) **Assigning authority and responsibility of component management**

2 The group engagement partner

2.1 Objectives

The group engagement partner has three main objectives:

(a) To determine whether it is appropriate to act as the auditor of the group financial statements

(b) To communicate effectively with the component auditors relating to the scope and timing of their work on financial information related to components and their findings

(c) To obtain sufficient appropriate audit evidence regarding the financial information of the components to enable an opinion to be formed on the group financial statements

2.2 The group engagement partner's responsibilities

Topic highlights

The group engagement partner is responsible for the **direction, supervision and performance** of the group audit engagement in compliance with HKSA and the Hong Kong Companies Ordinance S 141(4) and S 141(6).

HKSA 600.11

Under HKSA 600 (Clarified), the group engagement partner **has sole responsibility** to express an opinion on the group financial statements even for components that the group engagement partner has not audited. As a result, the auditor's report on the group financial statements **shall not refer** to a component auditor, unless required by law or regulation.

2.3 Quality control requirement for the group engagement partner

HKSA 600.4

The group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the **appropriate competence and capabilities** (HKSA 220 (Clarified)).

2.4 The group engagement partner's rights

Topic highlights

The group engagement partner has the right to require from component auditors the information and explanations they require, and to require the group management to take all reasonable steps to obtain the necessary information and explanations from subsidiaries.

The group engagement partner **has all the statutory rights and powers** in respect of their audit of the holding entity of access at all times to the holding entity's books, financial statements and vouchers.

Even where their responsibilities in this regard are not set down by statute, the component auditors should appreciate that the subsidiaries' financial statements will ultimately form a part of the group financial statements. In principle, the component auditors should therefore be prepared to **co-operate** with the **group engagement team**.

2.5 Acceptance and continuance

Topic highlights

For significant components the group engagement partner should consider whether **their participation** will be sufficient to obtain sufficient appropriate evidence and should determine how the work of the component auditors will affect the group audit.

HKSA 600.12

When considering whether to accept appointment or continue as auditors, the group engagement partner should determine whether "**sufficient appropriate audit evidence**" can reasonably be expected to be obtained in relation to the **consolidation process** and the financial information of the components on which to base the group audit opinion'. Where possible, a firm will tender for the audit of all significant components within a group. Where this is not possible, which may be for a wide variety of reasons, the group engagement team must identify the materiality of the portion of the financial statements he is responsible for to build an understanding of the group, its components, and their environments sufficient to identify which are significant components.

To obtain this understanding he will refer to the following sources:

In the case of **a new engagement**:

- Information provided by group management
- Communication with group management
- Where applicable, communication with the previous group engagement team or component auditors

If he is satisfied that group management will provide sufficient co-operation and access to carry out the audit effectively he may accept the engagement.

The **engagement partner** will also consider the following:

- The group structure – the group, its components and their environment
- Their knowledge of the component's business activities including the industry and regulatory, economic and political environments in which they operate
- The materiality of that part of the group that they do not audit and the risk of material misstatement in their financial statements before consolidation through fraud or error

- How the relationship with the component auditors can be managed effectively
- Whether the firm has the capability to perform more work
- The use of service organisations
- A description of **group-wide controls**
- The complexity of the **consolidation process**
- Instructions issued by group management to components and how centralised its controls are
- Whether component auditors outside of the group engagement partner's firm will perform work on the financial information of any of the subsidiaries
- Whether the group engagement auditors will have unrestricted access

For **continuing engagements**, the group engagement partner's ability to obtain sufficient appropriate audit evidence may be affected by **significant changes**, such as changes in organisational structure, the nature of business activities or concerns regarding either the integrity or competence of group's or subsidiaries' management.

Where components within the group are likely to be **significant components**, the group engagement partner evaluates the extent to which the group engagement team will be able to be involved in the work of those component auditors.

The group engagement partner must either **refuse to accept, or resign** from, the engagement if he concludes that it will not be possible to obtain sufficient appropriate audit evidence due to restrictions imposed by group management.

2.6 Planning and risk assessment

HKSA 600.15-21, 26-38

The most significant aspect of the planning and risk assessment process in this situation is the fact that all elements of the group financial statements are **not audited** directly by the group engagement team. Therefore, there is the risk that a component auditor may fail to detect a risk in the component's financial statements which becomes consolidated in the group financial statements. According to HKSA 600 (Clarified) it is not sufficient for the engagement team to rely only on the conclusions of the component auditor but must first evaluate the reliability of the component auditor and the work performed (see Section 2.6.2 below). The results of their assessment will then inform what further procedures are necessary.

The following are **examples** that may indicate risks of material misstatement of the group financial statements:

- **A complex group structure**, especially where there are frequent acquisitions, disposals or reorganisations.
- **Poor corporate governance structures**.
- **Non-existent or ineffective group-wide controls**, including inadequate group management information on monitoring of components' operations and their results.
- **Components operating in foreign jurisdictions** that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.
- **Business activities of components that involve high risk**.
- **Uncertainties regarding which components' financial information** require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example whether any special-purpose entities or non-trading entities exist and require incorporation.
- Unusual **related party** relationships and transactions.

- **Prior occurrences of intra-group account balances** that did not balance or reconcile on consolidation.
- **The existence of complex transactions** that are accounted for in more than one component.
- **Components' application of accounting policies** that differ from those applied to the group financial statements.
- **Components with different financial year-ends,** which may be utilised to manipulate the timing of transactions.
- Prior occurrences of **unauthorised or incomplete consolidation adjustments**.
- **Aggressive tax planning within the group**, or large cash transactions with entities in tax havens.
- **Frequent changes of auditors** engaged to audit the financial statements of components.

2.6.1 Overall strategy and audit plan

Under HKSA 600 (Clarified), the group engagement team shall formulate an **overall group audit strategy, develop a group audit plan and conduct ongoing reviews** to monitor progress against audit objectives.

2.6.2 Understanding the group, the component auditor and their environment

HKSA 600 (Clarified) stipulates that the group engagement team is to obtain an understanding of the component auditor. It goes on to describe what this means in practice:

(a) Assessment of whether the component auditor is **independent** and understands and will comply with the ethical requirements that are relevant to the group audit

(b) Whether the component auditor's **professional and technical competence** is sufficient to deal with the audit of the appropriate complexity

(c) Whether the group engagement team will be **involved in the work of component auditors** to the extent that it is necessary to obtain sufficient appropriate audit evidence

(d) Whether the component auditor operates in a **regulatory environment** that actively oversees auditors

There are various ways to obtain this information. For example, in the first year, the group engagement partner and his team may visit the component auditors for face-to-face discussions. Alternatively, the component auditor may be requested to confirm these matters in writing or to complete a pre-set questionnaire. The group engagement partner auditors may review the working papers of component auditors. Confirmations from professional bodies may also be sought and the reputation of the firm will be taken into account.

2.6.3 Component materiality

The group engagement team is responsible for setting the **materiality level for the group financial statements** as a whole. Materiality levels should also be set for components which are individually significant. These should be set at a lower level than the materiality level of the group as a whole. The group engagement team shall evaluate the appropriateness of **performance materiality** determined at the component level and determine the threshold for statements that cannot be regarded as **clearly trivial** to the group financial statements.

2.6.4 Work of the group engagement team

Work on individual significant component

HKSA 600 (Clarified) requires that the engagement team shall perform an audit of the financial information of the significant component using **component materiality** and the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements.

The group engagement team shall also determine the **nature, timing and extent** of its involvement in the work of the component auditors. Based on these factors the group auditors may perform the following procedures:

(a) Meeting with the component management or the component auditors to obtain an understanding of the component and its environment

(b) Reviewing the component auditor's overall audit strategy and audit plan

(c) Performing risk assessment procedures to identify and assess risks of material misstatement at the component level. These may be performed with the component auditor or by the group engagement team

(d) Discussing with the component auditor or component management regarding the component's business activities that are significant to the group and the audit procedures to be carried out

(e) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error, by considering fraud risk factors

(f) Reviewing the component auditor's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum including the conclusions drawn by the component auditors

(g) Considering significant findings of the component auditors

(h) Giving appropriate advice to component auditors

(i) Obtaining written representations from the component auditors

Work on component that is likely to include significant risks of material misstatement of the group financial statements

HKSA 600 (Clarified) requires that:

(a) the group engagement team, or a component auditor on its behalf, must perform an audit or review of the financial information of the component using **component materiality**;

(b) the group engagement team must also audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements; and

(c) specified audit procedures should be carried out.

Work on components other than significant components

HKSA 600 (Clarified) requires that:

(a) the group engagement team shall perform analytical procedures at group levels; and

(b) the group engagement team shall perform, or request a component auditor to perform, specific audit procedures.

Work on group-wide controls

HKSA 600 (Clarified) requires the group engagement team to test, or request a component auditor to test, the operating effectiveness of those controls (tests of controls) when:

(a) the nature, extent and timing of the work to be performed on the consolidation process or the financial information of components are based on the expectation that **group-wide controls are operating effectively**

(b) if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Further work on consolidation process

The group engagement team must design and perform further audit procedures on the consolidation process to response to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. The procedures involve evaluation of all the following:

(a) Whether all components have been included in the group financial statements

(b) The appropriateness, completeness and accuracy of consolidation adjustments and classification

(c) Whether any fraud risk factors or indicators of possible management bias exist in making accounting estimates

(d) Whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements when the financial information has not been prepared with the group accounting policies

(e) Whether appropriate adjustments have been made when financial statements prepared by the component auditor have different financial reporting period-end

Work on subsequent events

The group engagement team (or the component auditors) shall perform procedures designed to identify events at those components that occur **between the dates of the financial information of the components and the date of the auditor's report** on the group financial statements, and that may require adjustment to or disclosure in the group financial statements.

2.7 Evaluating the work of the component auditor

HKSA 600.42-45

For all entities in the group, the group engagement partner is required to perform a review of the work done by the component auditor. This is normally achieved by reviewing a report or questionnaire completed by the component auditor which highlights the key issues which have been identified during the course of the audit. The effect of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence should also be evaluated. On the basis of this review, the group engagement partner then needs to determine whether any additional procedures are necessary.

These may include:

(a) evaluating the component auditor's communication by discussing significant matters arising from that evaluation with the component auditor, management or group management;

(b) designing and performing further audit procedures. (These may be designed and performed with the component auditors, or by the group engagement partner);

(c) participating in the closing and other key meetings between the component auditors and component management; and

(d) reviewing other relevant parts of the component auditors' documentation.

If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed and whether they are to be performed by the component auditor or by the group engagement team.

2.8 Component auditor's responsibilities

A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component.

The component auditor should always **co-operate** with the group engagement partner.

If the component auditors have **no statutory obligation** but the group engagement team has stated the intention to use the work of the component auditors, they may need **consent** from the entity that they audit to communicate with the group engagement team. If the permission is refused, the component auditor should inform the group engagement team of the refusal.

The component auditor should inform the group engagement team of any work that cannot be carried out or any significant relevant matters. The component auditor has **sole responsibility** for the audit opinion on the financial statements of the component they audit.

The component auditor should not rely on the group engagement team to inform them of material information. For any communication to the group engagement team, the component auditors should consider confidentiality.

2.8.1 Additional local guidance on communication with the component auditor

In Hong Kong, where a holding company and its subsidiary are **incorporated in Hong Kong**, s 133(1)(a) of the Companies Ordinance imposes a duty on the subsidiary and its auditors to give to the auditors of the holding company such information and explanation as those auditors may **reasonably require** for the purposes of their duties as auditors of the holding company.

Where a holding company is incorporated in Hong Kong, but its subsidiary is not, s 133(1)(b) of the Companies Ordinance imposes a duty on the holding company, if required by its auditors to do so, to take all such steps as are reasonably open to it to obtain from the subsidiary such information and explanation as the group engagement team may reasonably require for the purpose of their duty as the group engagement team.

2.9 Reporting

Topic highlights

The group engagement partner takes sole responsibility for the group audit opinion.

The following are some of the conditions that a group engagement partner would face when considering issuing his audit report on the group financial statements:

CONDITION (1) – **If satisfied with the work performed by component auditors**

If the group engagement team is satisfied that the work of the component auditors is adequate for the purposes of the audit, **no reference** to the component auditors should be made in the group engagement team's report.

The group engagement partner has **sole responsibility for his firm's audit opinion**. If the group audit' report refers to component auditors, it may be misinterpreted as a qualification of the group audit opinion or as a division of responsibility.

CONDITION (2) – Where the group engagement partner concludes that the **work of the component auditor cannot be used** and it is not possible to perform additional procedures regarding the component that the component auditor's audit

The group engagement partner should consider the **implications for the group audit report** and may need to qualify if material, or give a disclaimer of opinion as there is a **limitation in the scope of work**.

CONDITION (3) – **Where component auditors' report contains a qualification or explanatory paragraph relating to fundamental uncertainty**

The group engagement partner should consider whether the qualification or uncertainty is **material in the context of the group**. It can be material to the component and not material in the group's perspective and qualification may not be required in respect of the group.

2.10 Communication

HKSA 600.40

The group engagement team shall communicate their requirements to the component auditors on a **timely basis**. This communication shall set out the work to be performed, the use to be made of that work and the form of the component auditor's communication with the group engagement team.

These communications include the following:

(a) A request that the component auditor confirms their co-operation with the group engagement auditors

(b) The ethical requirements that are relevant to the group audit and, in particular, independence requirements

(c) In the case of an audit or review of the financial information of the component, consider the component materiality

(d) Identified significant risks of material misstatement of the group financial statements, due to fraud or error that are relevant to the work of the component auditor. The group engagement partner requests the component auditor to communicate any other identified significant risks of material misstatement and the component auditor's responses to such risks

(e) A list of related parties prepared by group management and any other related parties of which the group engagement team is aware. Component auditors are requested to communicate any other related parties not previously identified

The group engagement team shall **evaluate** the component auditor's communication. The group engagement team shall determine if any additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

The group engagement partner should determine whether the group financial statements as a whole are misstated as part of the process of evaluation of the aggregate effect of any misstatements.

The group engagement team shall request the other auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall include the following:

- Whether the component auditor has complied with ethical requirements, being independent and competent
- Whether the component auditor has complied with the group engagement team's requirements
- Identification of the financial information of the component on which the component auditor is reporting
- Any instances of non-compliance with laws and regulations that could give rise to a material misstatement of the group financial statements
- A list of uncorrected misstatements of the financial information of the component
- Indicators of possible management bias
- Description of any identified significant deficiencies in internal control at the component level
- Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component
- Any other matters relevant to the group audit or that the component auditor wishes to draw attention to the group engagement team
- The component auditor's overall findings, conclusions or opinion

2.11 Communicating with group management and those charged with governance

HKSA 600.46

The following matters should be communicated to group management:

(a) Deficiencies in the design or operating effectiveness of group-wide controls

(b) Deficiencies that the group engagement team has identified in internal controls at components that are judged to be significant to the group

(c) Deficiencies that component auditors have identified in internal controls at components that are judged to be significant to the group

(d) Fraud identified by the group engagement team or component auditors or information indicating that a fraud may exist. Timely reporting should be communicated to the group management

(e) Group management may need to keep certain material sensitive information confidential

2.12 Communication with those charged with governance of the group

HKSA 600.49

The auditor should communicate the following matters to those charged with governance of the group:

(a) A summation of the work to be performed on the financial statements of the component

(b) A description of the extent of group engagement team's planned involvement in the work to be performed by component auditors on significant components

(c) Any areas where the work of the component auditor gives the engagement team concern about the quality of that auditor's work or their independence

(d) Any restrictions on the group audit, for instance, where the component's management may have limited access to data or information

(e) Any suspicions or evidence of fraud involving group management, component management, employees who have significant roles in group-wide controls or where fraud has caused a material misstatement in the assertions of the group financial statements.

Self-test question 1

You are the main auditor of Brandy Holdings, a Hong Kong listed entity, which has subsidiaries in Hong Kong and overseas, many of which are audited by other firms. All subsidiaries are involved in the manufacture or distribution of children's toys and have accounting periods the same as that of the holding entity.

(a) As the group engagement partner, describe the reasons why you would wish to review the work of the component auditors of the subsidiaries not audited by you.

(b) Describe the principal audit procedures you would carry out in performing such a review.

(The answer is at the end of the chapter)

3 Joint audit

Topic highlights

In a joint audit, more than one auditor is responsible for the audit opinion. In some jurisdictions they are compulsory.

Key term

A **joint audit** is one "where two or more auditors are responsible for an audit engagement and jointly produce an audit report to the entity".

Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.

The relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor falls outside the scope of HKSA 600 (Clarified). The management of the relationship is the affair of the firms involved, and extensive discussions and research should be taken concerning their respective experience, competence and working methods before a joint audit is commenced.

3.1 Reasons for a joint audit

Two or sometimes more firms of accountants may act as joint auditors for a number of reasons:

(a) **Takeover/merger**. The parent entity may insist that their auditors act jointly with those of the new subsidiary; working jointly creates some continuity at a time of critical change.

(b) **Diverse location**. An entity whose sites are widely separated geographically may find it convenient to have more than one set of auditors working collaboratively.

(c) **Political difficulties**. To comply with local legislation some overseas subsidiaries may need to employ local auditors who may act jointly with those engaged by the holding entity.

(d) Companies may prefer to use **local accountants**, while at the same time benefitting from the wider range of services or kudos provided by the involvement of a large national or "Big Four" firm.

(e) In some jurisdictions, such as France, it is compulsory as it is seen to improve the quality of the audit and ensure independence.

3.2 Accepting a joint audit

Before a joint audit is accepted there are many practical issues that must be addressed. The reputation of the other firm will be important and a thorough understanding is needed of their **experience** and **standards**. Each firm will look at the other for the auditing techniques used, will scrutinise the other working papers and establish whether they have had experience in similar engagements to ensure that working collaboratively will not be to the detriment of either party.

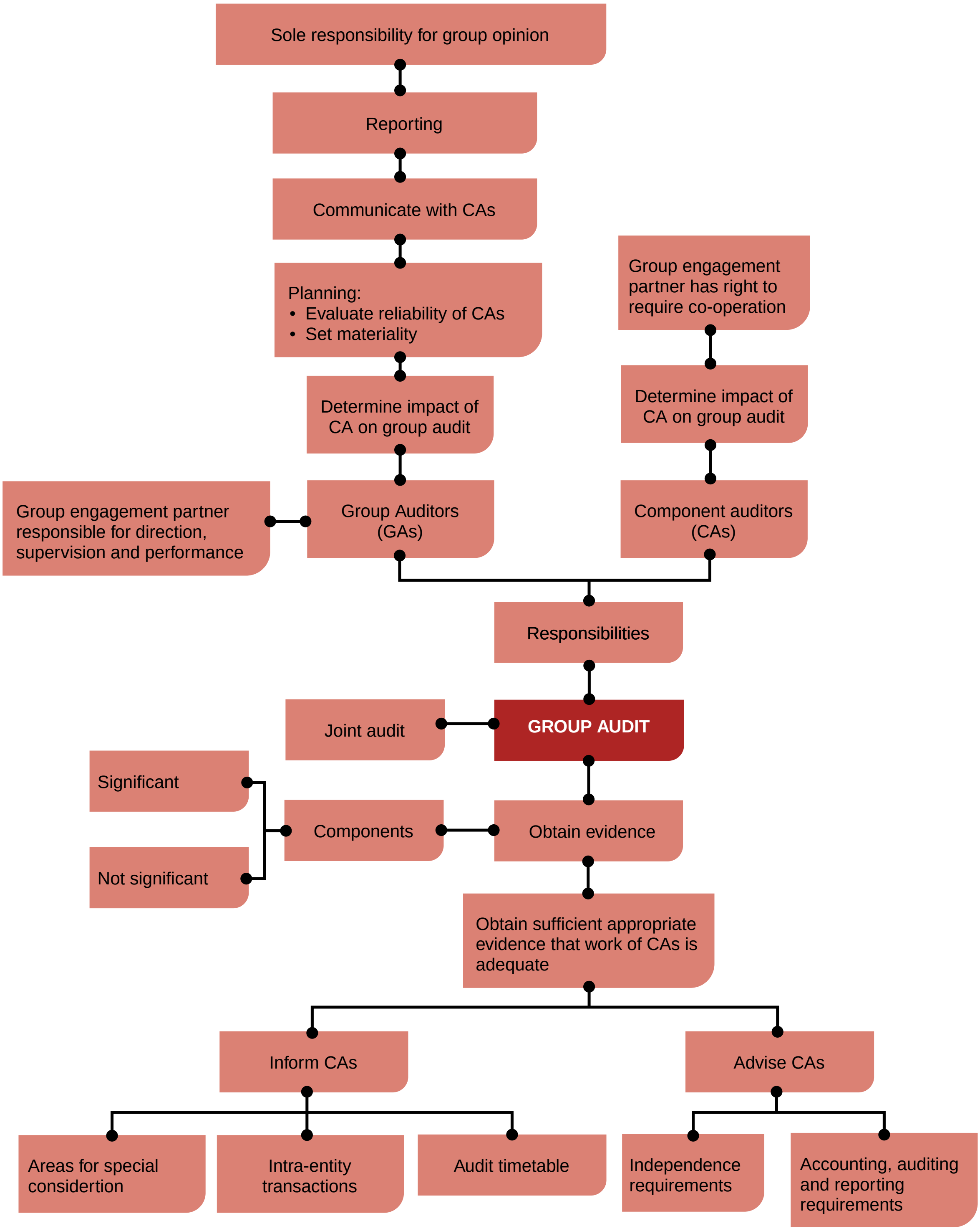
Where joint auditors are engaged, the audit engagement should be explained in similar terms by each set of auditors. The auditors should agree whether joint or separate letters should be sent to the entity. If other services are provided, separate letters will be needed.

Once a joint position has been accepted the joint auditors need to work together to develop the **programme** of work and how it is to be assigned to the respective firms.

3.3 Drawbacks and benefits of a joint audit

From the client's point of view the most likely drawback of a joint audit is the additional expense and time spent by senior management in engaging two or more firms. However, if the two firms have organised the work between them effectively the impact on costs should not be that great as there should not be duplication of effort, but a wider range of resources on which to draw. Further, by appointing joint auditors the client may access a higher degree of service than a single firm could provide and its use may help to raise audit service levels in general as auditors review each other's work and the threats of self-review, intimidation and so on are therefore reduced. These positive outcomes rely on the two firms working responsibly together to produce the best outcome for the client – that is, confidence in the financial statements – rather than point scoring against each other. If the auditors compete rather than collaborate the results may be poor and costly for the entity and ultimately detrimental to both firms. Regardless of what allocations of responsibility they decide, both firms are held jointly responsible for the whole audit and both sign the final audit report. Equally, both firms are **jointly liable** in the event of litigation whether or not they carried out the disputed area of the audit.

Topic recap


Sole responsibility for group opinion
Reporting
Communicate with CAs
Planning:
• Evaluate reliability of CAs
• Set materiality
Group engagement partner has right to require co-operation
Determine impact of CA on group audit
Determine impact of CA on group audit
Group engagement partner responsible for direction, supervision and performance
Group Auditors (GAs)
Component auditors (CAs)
Responsibilities
Joint audit
GROUP AUDIT
Significant
Components
Obtain evidence
Not significant
Obtain sufficient appropriate evidence that work of CAs is adequate
Inform CAs
Advise CAs
Areas for special considertion
Intra-entity transactions
Audit timetable
Independence requirements
Accounting, auditing and reporting requirements

Answer to self-test question

Answer 1

(a) **Reasons for reviewing the work of component auditors**

It may be stated in the notes that the financial statements of certain subsidiaries have been audited by other firms, but this does not discharge the group engagement team from any of their responsibilities.

The main consideration which concerns the audit of all group financial statements is that the group engagement partner is responsible to the shareholders of that entity for the audit opinion on the whole of the group financial statements.

The group engagement partner has to report to the shareholders on the truth and fairness of the view given by the financial statements of the entity and its subsidiaries dealt with in the group financial statements.

The group engagement team should have powers to obtain such information and explanations as they reasonably require from the subsidiary companies and their auditors, or from the parent entity in the case of overseas subsidiaries, in order that they can discharge their responsibilities as the group engagement partner.

HKSA 600 (Clarified) clarifies how the group engagement partner can carry out a review of the audits of components including subsidiaries in order to satisfy themselves that, with the inclusion of figures not audited by themselves, the group financial statements give a true and fair view.

The scope, standard and independence of the work carried out by component auditors are the most important matters which need to be examined by the group engagement team before relying on financial statements audited by them. The group engagement team needs to be satisfied that sufficient appropriate audit evidence has been obtained and that all material areas of the financial statements of subsidiaries have been audited satisfactorily and in a manner compatible with that of the group engagement team.

(b) The group engagement team should carry out the following work to review the component auditors' work:

(i) Send a questionnaire to all component auditors requesting detailed information on their work, including the following:

(1) details of the accounting policies of major subsidiaries (to ensure that these are compatible within the group)

(2) any limitations placed on the scope of the auditors' work

(3) an explanation of their general approach (in order to make an assessment of the standards of their work)

(4) the component auditors' opinion of the subsidiaries' overall level of internal control, and the reliability of their accounting records

(5) any qualifications, and the reasons for them, made or likely to be made to their audit reports

(ii) Carry out a detailed review of the other auditors' working papers on each subsidiary whose results materially affect the view given by the group financial statements. This review will enable the group engagement team to ascertain whether (*inter alia*) the following apply:

(1) All other working papers are comprehensive and explicit.

(2) The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit.

(3) The financial statements agree in all respects with the accounting records and comply with all relevant legal requirements and accounting standards.

(4) The audit work has been properly reviewed within the firm of auditors and any laid-down quality control procedures adhered to.

(5) Any points requiring discussion with the holding entity's management have been noted and brought to the group engagement partner's attention (including any matters which might warrant a qualification in the audit report on the subsidiary entity's financial statements).

(6) Adequate audit evidence has been obtained to form a basis for the audit opinion on both the subsidiaries' financial statements and those of the group.

(7) An up-to-date permanent file exists with details of the nature of the subsidiary's business, its staff organisation, its accounting records, previous year's financial statements and copies of important legal documents.

(8) The systems examination has been properly completed, documented and reported on to management after discussion.

(9) Tests of controls and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed.

(10) Minutes of board and general meetings have been scrutinised and important matters noted.

(11) The audit work has been carried out in accordance with approved auditing standards.

(12) The financial statements agree in all respects with the accounting records and comply with all relevant legal and professional requirements.

If the group engagement partner is not satisfied as a result of the above review, he should arrange for further audit work to be carried out either by the component auditors on their behalf, or jointly with them. The component auditors are fully responsible for their own work; any additional tests are those required for the purpose of the audit of the group financial statements.

Exam practice

Solid Inc — 31 minutes

Your team has just won a global audit proposal and is now engaged by Solid Inc. as their group auditor for the year ended 31 December 20X1 audit. Solid Inc. is a multinational company with annual revenue and total net assets exceeding US$1,000 million and US$30,000 million respectively, and has business worldwide in different industries. In two weeks' time you will be proposing your group audit plan to the senior management of Solid Inc.

Required

Through your discussion with the CEO and CFO, together with the other information gathered for your audit scoping and planning, what would be your audit response to the information gathered below, as a group auditor, to ensure the quality of the group audit?

(a) Solid Inc. has a retail business in Asia Pacific which contributed to the group's 20% revenue and 10% net profit. The retail business is audited by another reputable well-known audit firm and you have confidence in the competence of that audit firm.

(7 marks)

(b) Solid Inc. has a real estate project in Brazil with investments of over US$300 million. This is the first time that Solid Inc. has entered into the real estate industry. The project is now audited by a local auditor. You do not have much information about the local auditor in terms of competence, independence and objectivity.

(7 marks)

(c) Your team has been the auditor of Solid Inc.'s shipping business over a period of ten years before you were engaged as the group auditor. The partner in charge of the shipping business audit has extensive knowledge and experience with the client. He has been involved in the shipping business audit for seven years and has known some of the senior management of Solid Inc. for a long time.

(3 marks)

(Total = 17 marks)

HKICPA December 2012


chapter 19

Audit-related services and other assurance engagements

Topic list

1 Audit-related services
- 1.1 Reviews
- 1.2 Assurance assignments applied to review
- 1.3 Agreed-upon procedures
- 1.4 Compilations

2 Other assurance engagements
- 2.1 Assurance engagements other than audit and review of historical financial information

3 Pro forma financial information included in a prospectus
- 3.1 Assurance engagements to report of the compilations of pro forma financial information included in a prospectus
- 3.2 Requirements
- 3.3 Reporting
- 3.4 Accountants' reports on pro forma financial information in investment circulars

4 Preliminary announcement of annual results
- 4.1 Guidance for auditors

5 Comfort letters and due diligence meetings on financial and non-financial information
- 5.1 Comfort letters and due diligence meetings

6 Engagements to report on summary financial statements
- 6.1 Objectives
- 6.2 Engagement acceptance
- 6.3 Engagement procedures
- 6.4 Form of opinion
- 6.5 Report date
- 6.6 Elements of the auditor's report
- 6.7 Emphasis of matter and modified opinions
- 6.8 Comparatives and supplementary information
- 6.9 Auditor association

7 Audit of financial statements prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS)
- 7.1 Purposes of the PN
- 7.2 Definition of SME-FRF
- 7.3 The application of s. 141D of the Companies Ordinance
- 7.4 Audit procedures

Learning focus

Assurance and audit-related services are important areas for auditors in practice.

In recent years, the management of entities have been asked to provide more information to increase public accountability. As a result, auditors have been asked to report on this information, so giving rise to the need for assurance services.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.02	**Other assurance engagement requirements**	2
2.02.01	Identify the level of assurance and the issues relating to other assurance and non-assurance engagements including:	
2.02.01.01	Reviews	
2.02.01.02	Agreed-upon procedures	
2.02.01.03	Pro-forma financial information	
2.02.01.04	Investment circular reporting engagements	
2.02.01.05	Preliminary announcements of annual results	
2.02.01.06	Comfort letters	
2.02.01.07	Due diligence work	

1 Audit-related services

Topic highlights

Audit-related services may be assurance services (reviews) or not (agreed-upon procedures and compilations).

1.1 Reviews

HKSRE 2400 (Revised) – *Engagements to review Historical financial information* (Performed by practitioner who is not an auditor of the reporting entity)

HKSRE 2410 – *Review of interim financial information performed by the independent auditor of the entity*

(Performed by practitioner who is the auditor of the reporting entity)

HKSRE 2410.7, 8

Key term

Review engagements. The objective of a review engagement on the interim financial information is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, **anything has come to the auditor's attention** that causes the auditor to believe that the interim financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

Topic highlights

A **review** provides a **limited level** of assurance that the information subject to review is free of material misstatement. The review is expressed in the form of **negative assurance**.

The requirement under *The Rules Governing the Listing of Securities on the Hong Kong Stock Exchange (HKSE)* in Hong Kong is that interim reports of listed companies should be reviewed by the audit committee. If there is not an audit committee, the auditors should perform the review. The interim report covers the first six months of its financial year and it should comprise the statement of financial position, statement of profit or loss and other comprehensive income, the statement of cash flows, statement of movements in equity, comparative figures, accounting policies and explanatory notes.

1.1.1 HKSRE 2400 versus HKSRE 2410

A practitioner, who is the auditor of the entity, is engaged to perform a review of interim financial information performs the review in accordance with HKSRE 2410, as discussed in this Learning Pack.

Alternatively, when a practitioner who is not the auditor of an entity, undertakes an engagement to review financial statements he shall comply with HKSRE 2400. Since the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal controls as the auditors would have done, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review.

HKSRE 2400 was revised in December 2012 and is effective for reviews of financial statements for periods ending on or after 31 December 2013. The changes aim to enhance the quality and consistency of engagements to review historical financial statements, through revised requirements and guidance addressing:

- responsibilities
- work effort
- reporting considerations.

1.1.2 Difference between a review and an audit

The **objective** of a review of interim financial statements differs significantly from an audit which is conducted in accordance with HKSAs.

A review **does not** provide a basis for **expressing an opinion** as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

In addition, a review is **not designed to obtain reasonable assurance** that the interim financial information is free from material misstatement.

The auditor makes inquiries and performs analytical procedures in order to reduce to a moderate level of risk, the possibility of expressing an inappropriate conclusion when the interim financial information is materially misstated.

A review may bring significant matters affecting the interim financial information to the auditor's attention, but it **does not provide all of the evidence** that would otherwise be required in an audit.

1.1.3 General principles

Topic highlights

- **Assurance services** improve the quality of decision-making for users of information.
- **Assurance engagements** comprise the independent verification of data prepared by others and are often used for interim financial statements although there are many other uses. They are designed to give *reasonable* assurance or *limited* assurance.

HKSRE 2410.4, 5

When carrying out an interim review the auditor should adhere to the same **ethical principles** as when conducting the main audit of the financial statements. The same procedures also apply:

(a) The auditor should agree the **terms of the engagement** with the client. However, these will be different to those used for the audit, as the review is intended to achieve a lower level of assurance

(b) The auditor should design the necessary **quality control procedures** for the specific engagement, depending on its scope and nature

(c) The auditor will plan the audit, including obtaining background information about the entity to ensure the objectives of the review are achieved to the appropriate level of assurance. He will then design specific audit procedures in order to obtain the evidence he needs

The engagement should be performed with the same **professionalism**, **independence of mind** and attitude of **professional scepticism** as a full audit. The HKSRE requirements reflect the requirements of an audit because a review is a very similar exercise. However, the actual tests performed may differ as inquiry and analytical procedures are used to achieve the reasonable or limited level of assurance rather than the physical inspections and third party confirmations involved in the more rigorous annual audit which seeks to achieve a higher level of assurance.

Planning

HKSRE 2410.15

In order to obtain knowledge of the business: The inquiries and analytical procedures selected are based on the understanding of the entity, its internal controls and the auditor's judgment as to where the risks of material misstatement lie.

Planning	The auditor shall perform the following: • Read last year's audit and previous review files. • Consider any significant risks that were identified in the prior year audit. • Read the most recent and comparable interim financial information. • Consider materiality. • Consider the impact of any corrected or uncorrected misstatements in last year's financial statements. • Consider any financial accounting or reporting matters of current importance. • Consider the results of any interim audit work for this year's audit. • Consider the work of internal audit. • Inquire of management as to their assessment of the risk that the interim financial statements might be affected by fraud. • Inquire of management whether there have been any significant changes in business activity in the relevant period, and if so, their impact. • Inquire of management about any significant changes to internal controls and the potential effect on preparing the interim financial information. • Inquire of management how the interim financial information has been prepared and the reliability of the underlying accounting records. • Read the minutes of meetings of shareholders, those charged with governance and other appropriate committees. • Consider the effect of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements from previous audits. • Where relevant, communicate with other auditors auditing different components of the business. • Design and perform analytical procedures which will identify relationships and unusual items that may indicate a material misstatement. • Read the interim financial information and consider whether anything has come to the auditors' attention which suggests that it is not prepared in accordance with the applicable financial reporting framework. • Agree the interim financial information to the underlying accounting records. • Consider suitability to accept the assignment: independence, competence, available time to carry out the extent of work and so on.
Evidence	The auditor shall perform the following: • Document significant matters. • Use professional judgment and experience in determining nature, timing and extent of procedures. • Inquire about subsequent events. • Undertake further procedures if material misstatements are suspected.

1.1.4 Procedures

HKSRE 2410.21, 25-27, 34, Appendix 2

In a review engagement, the auditor will rely more heavily on procedures such as **inquiry and analytical review** than on more detailed substantive testing such as testing accounting records through inspection, observation or confirmation. There are two reasons for this:

(1) He is seeking a **lower level of assurance than for an audit**, so these forms of evidence are sufficient due to risk being lower

(2) Such techniques provide **indicators** to direct work to risk areas and from which to draw conclusions; they are **quick** and, therefore, **cost-effective**

(a) **Inquiries**

What the inquiries are about and what matters are the subject of analytical procedure will depend on the specific situation. Inquiries are primarily made to persons responsible for financial and accounting matters.

Auditors should make **inquiries** of members of management responsible for financial and accounting matters about:

(i) whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework;

(ii) whether there have been changes in accounting policies;

(iii) whether new transactions have required changes in accounting principle;

(iv) whether there are any known uncorrected misstatements;

(v) whether there have been unusual or complex situations, such as disposal of a business segment;

(vi) significant assumptions relevant to fair values;

(vii) whether related party transactions have been accounted and disclosed correctly;

(viii) significant changes in commitments and contractual obligations;

(ix) significant changes in contingent liabilities including litigation or claims;

(x) compliance with debt covenants;

(xi) matters about which questions have arisen in the course of applying the review procedures;

(xii) significant transactions occurring in the last days of the interim period or the first days of the next;

(xiii) knowledge or suspicion of any fraud;

(xiv) knowledge of any allegations of fraud;

(xv) knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information;

(xvi) whether all events up to the date of the review report that might result in adjustment in the interim financial information have been identified; and

(xvii) whether management has changed its assessment of the entity being a going concern.

The auditor should obtain **written representations** from management that it acknowledges its responsibility for the design and implementation of internal control, that the interim financial information is prepared and presented in accordance with the applicable financial reporting framework and that the effect of uncorrected misstatements are immaterial (a summary of these should be attached to the representations). Also that all **significant facts** relating to **frauds or non-compliance with law and regulations** has been disclosed to the auditor and that all **significant subsequent events** have been disclosed to the auditor.

The auditor should read the other information accompanying the interim financial information to ensure that it is not inconsistent with it.

If the auditors believe a matter should be adjusted in the financial information, they should **inform management** as soon as possible. If management does not respond within a reasonable time, then the auditors should inform those charged with governance. If they do not respond, then the auditor should consider whether to modify the report or to withdraw from the engagement and the final audit if necessary. If the auditors uncover fraud or non-compliance with laws and regulations, they should communicate that promptly with the **appropriate level of management**. The auditors should communicate matters of interest arising to those charged with governance.

(b) **Analytical procedures**

The practitioner should perform an **in-depth analytical review** of the statement of profit or loss and other comprehensive income and statement of financial position and document all work done to support the conclusion.

The following are some examples of analytical procedures to be performed:

(i) Comparing the interim financial statements/information with the interim financial statements/information of the immediately preceding interim period, with the interim financial statements/information of the corresponding interim period of the preceding financial year, with the interim financial statements/information that was expected by management for the current period, and with the most recent audited annual financial statements.

(ii) Comparing current interim financial statements/information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes to pretax income in the current interim financial statements/information with corresponding information in (a) budgets, using expected rates, and (b) financial statements/information for prior periods).

(iii) Comparing current interim financial statements/information with relevant non-financial information.

(iv) Comparing the recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and applying relationships that are reasonably expected to exist based on the auditor's understanding of the entity and of the industry in which the entity operates.

(v) Comparing ratios and indicators for the current interim period with those of entities in the same industry.

(vi) Comparing relationships among elements in the current interim financial statements / information with corresponding relationships in the interim financial statements / information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.

(vii) Comparing disaggregated data.

(c) **Other procedures**

In particular, HKSRE 2410 **specifically requires** the following procedures:

(i) Obtain evidence that the interim financial statements agrees to, or reconciles with, the underlying accounting records;

(ii) Inquire whether management has identified all events up to the date of the review report and consider the requirement of making adjustment and disclosures;

(iii) Inquire whether management has changed its assessment of the entity's ability to continue as a going concern;

(iv) When the auditor becomes aware of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall:

- inquire of management regarding future plans
- consider the adequacy of disclosure

(v) When the auditor becomes aware that a material adjustment must be made for the interim financial statements, the auditor shall make additional inquiries and perform other possible procedures; and

(vi) When uncorrected misstatements have come to the auditor's attention, the auditor shall evaluate whether the uncorrected misstatements are material to the interim financial statements.

In addition, he should apply **professional judgment** in determining the specific nature, extent and timeliness of the procedures and consider subsequent events for adjustments and disclosures.

1.1.5 Additional procedures for incoming auditor

An incoming auditor should pay more attention to the following additional procedures:

(a) Obtaining knowledge of the business

(b) Assessing the inherent risk of misstatement

(c) Inquiring of predecessor or reviewing predecessor auditor's documents for the preceding annual audit

(d) Considering the nature of any corrected misstatements, significant risks, significant accounting and reporting matters such as any overriding of controls by management or internal control weaknesses.

1.1.6 Reporting

HKSRE 2410.43, 45, 49, 55, Appendix 4-7

An external review is an **exercise similar to an audit**, which is designed to give a **reduced degree of assurance** concerning the proper preparation of a set of financial statements.

Negative assurance is given on review assignments.

The review report should contain a clear written expression of **negative assurance**. The practitioner should review and assess the conclusion drawn from the evidence obtained as the basis for the expression of negative assurance.

Based on the work performed, the practitioner should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or “are not presented fairly, in all material respects,”) in accordance with the applicable financial reporting framework.

Key term

Negative assurance is assurance of something in the absence of any evidence arising to the contrary. In effect, this means the auditor is saying, “I believe that this is reasonable because I have no reason to believe otherwise.”

HKSRE 2410 requires that:

(a) if the interim financial statements comprise a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, the review should contain a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information does not give a true and fair view, or does not present fairly, in all material respects, in accordance with the applicable financial reporting framework; and

(b) in other circumstances, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

Unqualified review report

When no matters have come to the attention of the auditor, he should give a **clear expression of negative assurance** in his report. An example of an unqualified review report is given in the appendix to the HKSRE, and it is reproduced here.

Report on Review of Interim Financial Information (Other interim financial information)

(Appropriate addressee)

Introduction

We have reviewed the interim financial information set out on pages 10 to 20 which comprise the condensed statement of financial position of ABC Entity as of 30 June 201X and the related condensed statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes. The directors are responsible for the preparation and presentation of this interim financial information in accordance with Hong Kong Financial Reporting Standards. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, "Review of Interim financial Information performed by the Independent Auditor of the Entity" issued by the Hong Kong Institute of Certified Public Accountants. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that interim financial information is not prepared, in all material aspects, in accordance with Hong Kong Financial Reporting Standards.

AUDITOR

Date

Address

Modified review report

Auditors should modify the review report in the following circumstances:

Modification	Situation
Express a qualified or adverse conclusion	When a matter has come to the auditor's attention that causes the auditor to believe that **a material adjustment should be made** to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework; or If a material **uncertainty that casts significant doubt** about the entity's ability to continue as a **going concern** is not adequately disclosed in the interim financial information. The report should include specific reference to the fact that there is such a material uncertainty.

Modification	Situation
Add an emphasis of matter paragraph	To highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern, provided that adequate disclosure is made in the interim financial information; and Consider modifying the review report by adding a paragraph to highlight a significant uncertainty (other than a going concern problem) that came to the auditor's attention, the resolution of which is dependent upon the future events and which may affect the interim financial information.

The auditor shall **communicate in writing to the appropriate level of management and to those charged with governance**, if the auditor is unable to complete the review, the reason why the review cannot be completed, and consider whether it is appropriate to issue a report.

Extract of review reports with a qualified conclusion for a departure from the applicable financial reporting framework (Complete set of general purpose financial statements)

Basis for Qualified Conclusion

Based on information provided to us by the directors, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalised to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalised at 31 March 201X, property would be increased by $ ………, long-term debt by $ ………, and net income and earnings per share (basic and diluted) would be increased (decreased) by $ ………, $ ………, and $ ………, respectively, for the six-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the interim financial statements do not give a true and fair view of *(or "do not present fairly, in all material respects,")* the financial position of the entity as at 31 March 201X, and of its financial performance and its cash flows for the six-month period then ended in accordance with [indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards].

Extract from review reports with an adverse conclusion for a departure from the applicable financial reporting framework

Basis for Adverse Conclusion

Commencing this period, the directors of the entity ceased to consolidate the financial statements of its subsidiary companies since the directors consider consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards]. Had consolidated financial statements been prepared, virtually every account in the interim financial statements would have been materially different.

Adverse Conclusion

Our review indicates that, because the entity's investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, these interim financial statements do not give a true and fair view of *(or "do not present fairly, in all material respects,")* the financial position of the entity as at 31 March 201X, and of its financial performance and its cash flows for the six-month period then ended in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards].

Review report: Limitation on scope not imposed by management

Introduction paragraph – as per standard report

Scope paragraph

Except as explained in the following paragraph …. – as per standard report.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totalling $ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of *(or "does not present fairly, in all material respects,")* the financial position of the entity as at 31 March 201X, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards).

AUDITOR

Date

Address

Self-test question 1

Jackson CPA is the auditor for Sparkle Jewellery Limited and is also appointed to review and report on the interim financial report of Sparkle Jewellery for the six months ended 30 June 20Y0.

How does a review of an interim financial report differ from an audit of financial statements?

(The answer is at the end of the chapter)

1.1.7 Documentation

The auditor should **prepare review documentation** that is sufficient and appropriate to provide a basis for the auditor's conclusion and to provide evidence that the review was performed in accordance with the HKSRE and applicable legal and regulatory requirements.

The documentation enables an **experienced auditor** having no previous connection with the engagement to understand the nature, timing and extent of the **inquiries** made, and **analytical and other review procedures** applied, information obtained, and any significant matters considered during the performance of the review, including the disposition of such matters.

1.2 Assurance assignments applied to review

There are two types of assurance engagements which can be applied to reviews since these are a type of assurance service:

(a) An **attestation** engagement where the accountant declares that a given premise is either correct or not

(b) A **direct reporting** engagement, where the accountant reports on issues that have come to his attention during the course of his review

Example: Attestation engagement

Auditors may sometimes be asked to **review interim financial information**. In such an engagement, the auditor is being asked to attest assertions made, such as:

(a) the accounting policies used are consistent with those used in the prior year financial statements

(b) no material modifications to the interim financial information as it has been presented are required

(c) review procedures to secure compliance with quality control requirements

Example: Direct reporting engagement

A direct reporting engagement is where the accountant reports on issues that have come to his attention during the course of the review.

An example of a direct reporting engagement is a "**due diligence**" engagement.

Key term

Due diligence reviews are a specific type of review engagement. A typical due diligence engagement is where an adviser (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers. When a company is taken over or merged, all parties need to be assured that what is purported to be actually is. It can be carried out by actuaries, surveyors or lawyers. Normally, a takeover is not completed until a due diligence report has been completed.

It may include some or all of the following aspects:

(a) Financial due diligence (a review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations)

(b) Operational and IT due diligence (extent of operational and IT risks, including quality of systems, associated with a target business)

(c) People due diligence (key staff positions under the new structure, contract termination costs and cost of integration)

(d) Regulatory due diligence (review of the target's level of compliance with relevant regulation)

(e) Environmental due diligence (environmental, health and safety and social issues in a target)

1.3 Agreed-upon procedures

Topic highlights

In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures to which the auditor and the entity and any appropriate third parties have agreed and to report on **factual findings**.

HKSRS 4400.4, 5, 6

Key term

Agreed-upon procedures assignment. In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on **factual findings**. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. No assurance will be expressed on the financial information.

HKSRS 4400.7, 18

Agreed-upon procedures assignments are discussed in HKSRS 4400 *Engagements to Perform Agreed-upon Procedures Regarding Financial Information*.

1.3.1 Accepting appointment

The auditor should ensure with representatives of the entity, and ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

1.3.2 Carrying out procedures and reporting

The auditor should have complied with HKICPA's Professional Ethics Statements and should agree an engagement letter with the clients stating the agreed upon procedures to be performed, and that the distribution of the report of factual findings is restricted to the specified parties.

The auditors should plan the assignment. They should carry out the agreed-upon procedures, documenting their process and findings.

The report of factual findings should contain:

(a) Title

(b) Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures)

(c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied

(d) A statement that the procedures performed were those agreed upon with the recipient

(e) A statement that the engagement was performed in accordance with the Hong Kong Standards on Auditing applicable to agreed-upon procedure engagements, or with alternative standards or practices

(f) When relevant, a statement that the auditor is not independent of the entity

(g) Identification of the purpose for which the agreed-upon procedures were performed

(h) A listing of the specific procedures performed

(i) A description of the auditor's factual findings, including sufficient details of errors and exceptions found

(j) Statement that the procedures performed do not constitute either an audit or a review, and, as such, **no assurance is expressed**

(k) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported

(l) A statement that the report is restricted to those parties that have agreed to the procedures to be performed

(m) A statement, when applicable, that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole

(n) Date of the report

(o) Auditor's address

(p) Auditor's signature

Self-test question 2

The Capital Investment Entrant Scheme facilitates the application for Hong Kong residence by capital investment. An applicant may engage a practising certified public accountant to issue a Report of Factual Findings to assist him/her to demonstrate that he/she meets certain requirements of rules governing the scheme.

Required

Explain in general the nature of the practising certified public accountant’s engagement to issue such a Report of Factual Findings.

HKICPA February 2010

(The answer is at the end of the chapter)

1.3.3 Operational audits

Operational audits are different to compliance audits in that the scope is more extensive. As part of an operational audit, an internal audit department might undertake a compliance audit, but the scope **also includes an assessment of the effectiveness** of the procedures that are being audited.

As such, an operational audit is more like an agreed-upon procedures engagement. While an element of assurance is given (particularly with regard to the compliance elements of the assignment), the audit is designed with the intention of the internal auditor drawing his own conclusions about the systems from the work he has done.

1.4 Compilations

Topic highlights

In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information.

HKSRS 4410 (Revised) *Compilation Engagements* was issued in July 2012 and is effective for compilation engagement reports dated on or after 1 July 2013. It clarifies the practitioner's role and responsibilities in a compilation engagement and matters that need to be considered when accepting such engagements, and emphasises the importance of quality control. It also expands the traditional compilation engagement report to make clear to users the practitioner's contribution to the compiled financial information presented by management, and the key features of a compilation engagement.

HKSRS 4410.17(b)

Key term

Compilation engagement. An engagement in which a practitioner applies accounting and financial reporting expertise to **assist management in the preparation and presentation of financial information** of an entity in accordance with an applicable financial reporting framework, and reports as required by this HKSRS.

HKSRS 4410 (Revised) applies to compilation engagements for historical financial information. The HKSRS may be applied, adapted as necessary, to **compilation engagements for financial information** other than historical financial information, and to **compilation engagements for non-financial information.**

1.4.1 The compilation engagement

HKSRS 4410.5

Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity. The value of a compilation engagement performed in accordance with this HKSRS to users of financial information results from the **application of the practitioner's professional expertise** in accounting and financial reporting and compliance with professional standards, including relevant ethical requirements, and the clear communication of the nature and extent of the practitioner's involvement with the compiled financial information.

A compilation engagement is not an assurance engagement, therefore the practitioner is not required to verify the accuracy or completion of the information provided by management, or to express an audit opinion or review conclusion.

Management retains responsibility for the financial information and the basis on which it is prepared and presented, including the application of appropriate accounting policies and the development of reasonable accounting estimates.

Different financial reporting frameworks can be used to prepare and present financial information, ranging from a simple entity-specific basis of accounting to established financial reporting standards.

1.4.2 Conducting a compilation engagement in accordance with this HKSRS

Understanding of HKSRS

HKSRS 4410.18 - 27

The practitioner shall have an **understanding** of the entire text of HKSRS 4410 (Revised), including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

The practitioner shall comply with each requirement of this HKSRS unless a particular requirement is not relevant to the compilation engagement.

Ethics

The practitioner shall comply with relevant **ethical requirements**.

Professional judgment

The practitioner shall **exercise professional judgment** in conducting a compilation engagement. Professional judgment is essential to the proper conduct of a compilation engagement. This is because interpretation of relevant ethical requirements and the requirements of this HKSRS, and the need for informed decisions throughout the performance of a compilation engagement, require the application of relevant knowledge and experience to the facts and circumstances of the engagement.

Engagement level quality control

The engagement partner shall take responsibility for:

(a) The **overall quality of each compilation engagement** to which that partner is assigned; and

(b) The engagement being performed in accordance with the firm's **quality control policies and procedures**.

Engagement acceptance

The practitioner shall **not accept the engagement** unless the practitioner has agreed the terms of engagement with management, and the engaging party if different. The practitioner shall record the agreed terms of engagement in an engagement letter or other suitable form of written agreement, prior to performing the engagement.

On **recurring** compilation engagements, the practitioner shall evaluate whether circumstances, including changes in the engagement acceptance considerations, require the terms of engagement to be revised and whether there is need to remind management of the existing terms of engagement.

Communication with management and those charged with governance

The practitioner shall communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the compilation engagement, all matters concerning the compilation engagement that, in the practitioner's professional judgment, are of sufficient importance to merit the attention of management or those charged with governance, as appropriate.

1.4.3 Performing the engagement

The practitioner's understanding

HKSRS 4410.28 - 38

The practitioner shall **obtain an understanding** of the following matters sufficient to be able to perform the compilation engagement:

(a) The entity's **business and operations**, including the entity's accounting system and accounting records; and

(b) The **applicable financial reporting framework**, including its application in the entity's industry.

Other examples of matters the practitioner may consider in obtaining an understanding of the entity's business and operations, and the applicable financial reporting framework include:

- The **size and complexity** of the entity and its operations
- The **complexity** of the financial reporting framework
- The **entity's financial reporting obligations** or requirements, whether they exist under applicable laws and regulation, under the provisions of a contract or other form of agreement with a third party, or in the context of voluntary financial reporting arrangements
- The **level of development of the entity's management and governance structure** regarding management and oversight of the entity's accounting records and financial reporting systems that underpin the preparation of financial information of the entity
- The level of **development and complexity** of the entity's financial accounting and reporting systems and related controls
- The nature of the entity's assets, liabilities, revenues and expenses

Compiling the financial information

The practitioner shall **compile** the financial information using the records, documents, explanations and other information, including significant judgments, provided by management.

The practitioner shall **discuss** with management, or those charged with governance as appropriate, those **significant judgments,** for which the practitioner has provided assistance in the course of compiling the financial information.

Prior to completion of the compilation engagement, the practitioner shall read **the compiled financial information** in the light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework.

If, in the course of the compilation engagement, the practitioner **becomes aware** that the records, documents, explanations or other information, including significant judgments, provided by management for the compilation engagement are **incomplete, inaccurate or otherwise unsatisfactory**, the practitioner shall bring that to the attention of management and request the additional or corrected information.

If the practitioner is **unable to complete the engagement** because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If the practitioner **becomes aware** during the course of the engagement that:

(a) The compiled financial information does not adequately refer to or describe the applicable financial reporting framework;

(b) Amendments to the compiled financial information are required for the financial information not to be materially misstated; or

(c) The compiled financial information is otherwise misleading, the practitioner shall propose the appropriate amendments to management.

If management declines, or **does not permit the practitioner to make the proposed amendments** to the compiled financial information, the practitioner shall **withdraw** from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If withdrawal from the engagement is not possible, the practitioner shall determine the **professional and legal responsibilities** applicable in the circumstances.

The practitioner shall obtain an **acknowledgement** from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information.

Documentation

The practitioner shall include in the engagement documentation:

(a) Significant matters arising during the compilation engagement and how those matters were addressed by the practitioner;

(b) A record of how the compiled financial information reconciles with the underlying records, documents, explanations and other information, provided by management; and

(c) A copy of the final version of the compiled financial information for which management or those charged with governance, as appropriate, has acknowledged their responsibility, and the practitioner's report.

1.4.4 The Practitioner's Report

An important purpose of the practitioner's report is to clearly **communicate the nature of the compilation engagement**, and the practitioner's role and responsibilities in the engagement.

The practitioner's report issued for the compilation engagement shall be in writing, and shall include the following elements:

(a) The report title;

(b) The addressee(s), as required by the terms of the engagement;

(c) A statement that the practitioner has compiled the financial information based on information provided by management;

(d) A description of the responsibilities of management, or those charged with governance as appropriate, in relation to the compilation engagement, and in relation to the financial information;

(e) Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information;

(f) Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates;

(g) A description of the practitioner's responsibilities in compiling the financial information, including that the engagement was performed in accordance with this HKSRS, and that the practitioner has complied with relevant ethical requirements;

(h) A description of what a compilation engagement entails in accordance with this HKSRS;

(i) Explanations that:

Since a compilation engagement is **not an assurance engagement**, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation; and

Accordingly, the practitioner **does not express an audit opinion** or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework.

(j) If the financial information is prepared using a special purpose financial reporting framework, an explanatory paragraph that:

Describes the purpose for which the financial information is prepared and, if necessary, the intended users, or contains a reference to a note in the financial information that discloses this information; and

Draws the attention of readers of the report to the fact that the financial information is prepared in accordance with a special purpose framework and that, as a result, the information may not be suitable for other purposes;

(k) The date of the practitioner's report;

(l) The practitioner's signature; and

(m) The practitioner's address.

2 Other assurance engagements

Topic highlights

Assurance engagements should only be accepted if the firm meets the requirements of the *Code of Ethics for Professional Accountants* and HKSQC 1.

2.1 Assurance engagements other than audit and review of historical financial information

HKSAE 3000.4, 6, 18-19, 22, 33, 46

Here, we shall focus on assurance engagements on subjects other than historical financial information (which we have already looked at in the form of audits and reviews) as we look at the guidance in HKSAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information.*

Ethical requirements, quality control procedures and engagement acceptance should be considered.

The practitioner should assess the appropriateness of the subject matter and suitability of the criteria to evaluate or measure the subject matter.

The practitioner should plan the engagement and perform the engagement with an attitude of professional scepticism.

In additional the following should be performed:

(a) Obtain understanding of the subject matter

(b) Identify and assess the risk of the subject matter information being materially misstated and reduce the risk

(c) Consider materiality level

(d) Design and perform further evidence gathering procedures

(e) Obtain sufficient appropriate evidence to form a conclusion, evaluate at the end whether purpose has been achieved

(f) Obtain relevant representations

(g) Document findings

(h) Consider need for an expert who has adequate skills and knowledge

(i) Written assurance report and qualification is required if there is any limitation on the scope or disagreement with management

2.1.1 Compliance audits

Compliance audits are the traditional realm of internal auditors. They involve having a knowledge of the entity's policy and carrying out tests to ensure that the policy is being followed in practice. The accountant determines whether an entity has **complied with specified policies**, procedures, laws, therefore it requires established criteria. The accountant should determine the extent of compliance with that criteria.

As such, compliance audits tend to fall into the category of internal audit providing assurance services, as discussed above. This is because management is employing them to give them assurance that certain criteria have been met.

Example

PN810.1 Insurance brokers' compliance with Insurance Authority or review of annual financial reports of a non-governmental organisation

The engagement may be performed by independent auditors, external auditors or internal auditors and government auditors.

2.1.2 Performance audit (Value for money audits) (VFM)

The **assessment** of economy, efficiency and effectiveness should be a part of the normal process of any entity, public or private. Management should carry out **performance reviews** as a regular feature of their control responsibilities.

In a VFM audit, the objectives of a particular programme or activity need to be specified and understood in order for a proper assessment of whether value for money has been achieved to be made.

(a) In a **profit-seeking entity**, objectives can be expressed financially in terms of target profit or return. The entity, and profit centres within it, can be judged to have operated **effectively** if they have **achieved a target profit** within a given period. Shareholders might be interested in value for money

(b) In **non-profit seeking entities**, effectiveness cannot be measured this way, because the entity has non-financial objectives. The **effectiveness** of performance in such entities could be measured in terms of whether **targeted non-financial objectives have been achieved**, but as we have seen there are several problems involved in trying to do this. In a **non profit-targeted** entity, value for money can be extremely important. Interested parties (stakeholders) might be **trustees** and **donors**. In this case, **criteria** would be **objectives set** within the system.

Public sector entities are now under considerable **pressure** to prove that they operate economically, efficiently and effectively, and are encouraged from many sources to draw up **action plans** to achieve VFM as part of the continuing process of good management.

VFM is important **whatever level of expenditure** is being considered. Negatively, it may be seen as an approach to spreading costs in public expenditure fairly across services but positively it is necessary to ensure that the desired impact is achieved with the minimum use of resources. Therefore, VFM audits are normally conducted by government auditors on government entities.

Programme audits

Consideration should be given to:

- the extent of desired results or benefits established by authorising body
- effectiveness of programmes, activities or functions
- whether entity has complied with significant laws or regulations

Effective or efficient audit

Consideration should be given to:

- whether the entity has acquired, protected and used the resources economically and efficiently
- causes of inefficiencies and ineffectiveness
- whether the entity has complied with laws and regulations economically and effectively

2.1.3 Assurance reports on controls at a Service Organisation

HKSAE 3402.8

HKSAE 3402 *Assurance reports on controls at a service organisation* 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.

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;
(b) An agreed-upon procedures report on controls at a service organisation.

2.1.4 Assurance engagements on greenhouse gas statements

HKSAE 3410 *Assurance engagements on greenhouse gas statements* is a new standard which was issued in November 2012.

Given the link between **greenhouse gas (GHG)** emissions and climate change, many entities are quantifying their GHG emissions for internal management purposes, and many are also **preparing a GHG statement**:

(a) As part of a regulatory disclosure regime;

(b) As part of an emissions trading scheme; or

(c) To inform investors and others on a voluntary basis.

Therefore, the practitioner's conclusion in an assurance engagement may cover information in addition to a GHG statement.

HKSAE 3410 addresses practitioners' responsibilities in identifying, assessing, and responding to risks of material misstatement when engaged to report on greenhouse gas statements. It sets out requirements and guidance on the work effort and reporting responsibilities of practitioners for both reasonable and limited assurance engagements. HKSAE 3410 is applicable to a broad range of situations, from emissions from electricity used at a single office, to emissions from complex physical or chemical processes at several facilities across a supply chain. It is effective for assurance reports covering periods ending on or after 30 September 2013.

3 Pro forma financial information included in a prospectus

Topic highlights

The auditor must obtain sufficient appropriate evidence that the pro forma financial information has been properly compiled by the directors.

3.1 Assurance engagements to report on the compilation of pro forma financial information included in a prospectus

A new standard HKSAE 3420 *Assurance engagements to report on the compilation of pro forma financial information included in a prospectus* has been issued in April 2013. This deals with reasonable assurance engagements undertaken by a practitioner on a responsible party's compilation of pro forma financial information included in a prospectus. The HKSAE applies where:

- Such reporting is required by securities law or the regulation of the securities exchange ("relevant law or regulation") in the jurisdiction in which the prospectus is to be used; or
- This reporting is generally accepted practice in such a jurisdiction.

The new standard expands on how HKSAE 3000 is applied in this particular situation. Compliance with this standard also requires that the provisions of HKSAE 300 are also complied with.

HKSAE 3420.11

Key terms

Pro forma financial information is financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for the purposes of illustration.

A **prospectus** is a document issued pursuant to legal and regulatory requirements relating to the entity's securities on which it is intended that a third party should make an investment decision.

Applicable criteria are the criteria used by the responsible party when compiling the pro forma financial information.

3.1.1 Purpose of pro forma financial information

The purpose of the pro forma information is to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for the purposes of the illustration. This is achieved by applying pro forma adjustments to the unadjusted financial information. Pro forma financial information does not represent the entity's actual financial position, financial performance or cash flows.

3.2 Requirements

The basic purpose of the assurance engagement is to perform procedures to enable the practitioner to assess whether the applicable criteria used by the responsible party in the compilation of the pro forma information provide a reasonable basis for presenting the effects of the event or transaction, whether the adjustments made reflect the proper application of those adjustments. It also involves evaluating the overall presentation of the pro forma financial information.

In planning and performing the engagement the auditor must consider the following:

3.2.1 Assessing the suitability of the applicable criteria

The practitioner must assess whether:

HKSAE 3429.14

(a) The unadjusted financial information has been extracted from an appropriate source

(b) The pro forma adjustments are directly attributable to the event or transaction, factually supportable and consistent with the entity's applicable financial reporting framework and relevant accounting policies

(c) Appropriate presentation and disclosures have been made

Sources for factual support for adjustments include:

- Purchase and sale agreements
- Financing documents, such as debt agreements
- Independent valuation reports
- Other documents relating to the event or transaction
- Published financial statements
- Other financial information disclosed in the prospectus
- Relevant legal or regulatory actions e.g. taxation
- Employment agreements
- Actions to those charged with governance

3.2.2 Materiality

HKSAE 3420.16

Materiality in this context does not depend on a single quantitative measure. Instead it depends on the size and nature of the omission or inappropriate application of an element of the compilation, whether or not intentional. Judgment about the size and nature of these aspects will depend on:

- The context of the event or transaction
- The purpose for which the pro forma information is being compiled
- The related engagement circumstances

The risk of pro forma financial information not being compiled in all material respects on the basis of the applicable criteria may arise when there is evidence of for example:

- Use of an inappropriate source from which to extract the unadjusted financial information
- Incorrect extraction of the unadjusted financial information from an appropriate source
- The misapplication of accounting policies or the failure of the adjustments to be consistent with the entity's accounting policies
- A mathematical mistake
- Inadequate or incorrect disclosures

3.2.3 Obtaining an understanding of how the pro forma information has been compiled

The practitioner is required to obtain an understanding of how the pro forma financial information has been compiled. This includes obtaining an understanding of:

(a) The event or transaction in respect of which the pro forma financial information is being compiled

(b) How the responsible party has compiled the information

(c) The nature of the entity and any acquiree or divestee

(d) Relevant industry, legal, regulatory and other external factors

(e) The applicable financial reporting framework

Procedures to obtain this understanding may include:

- Inquiries of the responsible party
- Inquiries of those charged with governance
- Reading relevant supporting documentation
- Reading minutes of meetings with those charged with governance

HKSAE 3420.18 - 20

3.2.4 Obtaining evidence about the appropriateness of the source from which the unadjusted financial information has been extracted

HKSAE 3420 requires the practitioner determines whether the responsible party has extracted unadjusted financial information from an appropriate source.

Factors that affect the appropriateness of the source include whether there is an audit or a review report on the source and whether the source :

- Is permitted or specifically prescribed by the relevant law or regulation
- Is clearly identifiable
- Represents a reasonable starting point, including whether it is consistent with the entity's accounting policies

If there is no audit or review report the practitioner is required to perform procedures to be satisfied that the source is appropriate. These procedures would include:

- Inquiries of the responsible party
- If the practitioner has audited or reviewed the preceding annual or interim financial information, considering the findings of these
- Corroborating the information provided by the responsible party when the responses appear inconsistent with the practitioner's understanding
- Comparing the source with the corresponding prior period financial information and discussing significant changes with the responsible party

If a modified audit opinion or review opinion has been expressed on the source information (and the relevant law or regulation does not prohibit its use) the auditor must evaluate the potential consequences of this, in particular whether it affects the practitioner's ability to report on the engagement.

If the source information is not appropriate the practitioner must discuss the situation with the responsible party. If the matter cannot be resolved the practitioner must consider what further action to take. This may include withholding the report, withdrawing from the engagement and seeking legal advice.

HKSAE 3420.21 - 22

3.2.5 Obtaining evidence about the appropriateness of the pro forma adjustments

The practitioner is required to assess whether the pro forma adjustments illustrate the impact of the event or transaction and whether they are in accordance with the applicable criteria. The practitioner must determine whether the adjustments are:

(a) Directly attributable to the event or transaction

(b) Factually supportable

(c) Consistent with the applicable financial reporting framework

HKSAE 3420.25

3.2.6 Obtaining evidence about the calculations within the pro forma financial information

The practitioner must determine whether the calculations are mathematically correct.

3.2.7 Evaluating the presentation

Evaluation of the presentation includes consideration of:

- The overall presentation, including whether historical and other financial information is clearly distinguished
- Whether the pro forma financial information and related notes illustrate the impact of the event or transaction in a manner that is not misleading
- Whether disclosures enable the intended users to understand the information conveyed
- Whether the practitioner has become aware of any significant subsequent events

HKSAE 3420.28

3.2.8 Written representations

The practitioner must request the following written representations:

In compiling the pro forma information, the responsible party has identified all appropriate pro forma adjustments necessary to illustrate the impact of the event or transaction at the date or for the period of illustration

The pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria.

3.3 Reporting

3.3.1 Unmodified opinion

The practitioner will issue an unmodified opinion when he concludes that the pro forma financial information has been compiled in all material respects by the responsible party on the basis of the applicable criteria.

HKSAE 3420 Appendix 1

INDEPENDENT PRACTITIONER'S ASSURANCE REPORT ON THE COMPILATION OF PRO FORMA FINANCIAL INFORMATION INCLUDED IN A PROSPECTUS

(Appropriate addressee)

Report on the compilation of pro forma financial information included in a prospectus

We have completed our assurance engagement to report on the compilation of pro forma financial information of ABC Company by (the responsible party). The pro forma financial information consists of (the pro forma net asset statement as at (date)), (the prof forma statement of profit or loss for the period ended (date)), the pro forma cash flow statement for the period ended (date)) and related notes (as set out on pages xx-xx of the prospectus issued by the company). The applicable criteria on the basis of which (the responsible party) has compiled the pro forma financial information are (specified in (Securities Regulation XX) and described in (Note X).

The pro forma financial information has been compiled by (the responsible party) to illustrate the impact of the (event or transaction) (set out in Note X) on the (company's financial position as at specify date) (and) (the company's financial performance (and cash flows) for the period ended specify date) as if the (event or transaction) had taken place at (specify date) (and specify date respectively). As part of the process information about the company's (financial position), (financial performance) (and cash flows) has been extracted by (the responsible party) from the company's financial statements (for the period ended (date)) on which ((an audit/(a review) report)/(no audit or review report) has been published.

(*The responsible party's) responsibility for the pro forma financial information*

(The responsible party is responsible for compiling the pro forma financial information on the basis of the (applicable criteria)).

Practitioner's responsibilities

Our responsibility is to express an opinion (as required by (Securities Regulation XX)) about whether the pro forma financial information has been compiled, in all material respects, by (the responsible party) on the basis of the (applicable criteria).

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements (HKSAE) 3420 *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*, issued by the Hong Kong Institute of Certified Public Accountants. This standard requires that the practitioner complies with ethical requirements and plans and performs procedures to obtain reasonable assurance about whether (the responsible party) has compiled, on all material respects, the pro forma financial information on the basis of the (applicable criteria).

For the purposes of this engagement we are not responsible for updating or reissuing any reports or opinions on any historical financial information used in compiling the pro forma financial information, nor have we, in the course of this engagement, performed an audit or review of the financial information used in compiling the pro forma financial information.

The purpose of the pro forma financial information included in the prospectus is solely to illustrate the impact of a significant event or transaction on unadjusted financial information of the entity as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration. Accordingly, we do not provide any assurance that the actual outcome of the event or transaction at (specify date) would have been presented.

A reasonable assurance engagement to report on whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria involves performing procedures to assess whether the applicable criteria used by the (the responsible party) in the compilation of the pro forma financial information provide a reasonable basis for presenting the significant effects directly attributable to the event or transaction, and to obtain sufficient appropriate evidence about whether:

- The related pro forma adjustments give appropriate effect to those criteria; and
- The pro forma financial information reflects the proper application of those adjustments to the unadjusted financial information.

The procedures selected depend on the practitioner's judgment, having regard to the practitioner's understanding of the nature of the company, the event or transaction in respect of which the pro forma financial information has been compiled, and other relevant engagement circumstances.

The engagement also involves evaluating the overall presentation of the pro forma financial information.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion, (the pro forma financial information has been compiled, in all material respects, on the basis of the (applicable criteria) /(the pro forma financial information has been properly compiled on the basis stated)).

Report on other legal or regulatory requirements.

(Relevant law or regulation may require the practitioner to express an opinion on other matters.)

(Practitioner's signature)

(Date of practitioner's report)

(Practitioner's address)

HKSAE 3420.32 - 34

3.3.2 Modified opinion

Where relevant law or regulation precludes the publication of a prospectus with a modified opinion but the auditor concludes that a modified opinion is required the practitioner should discuss the situation with the responsible party. If the responsible party does not make the necessary changes the practitioner must:

- Withhold the report
- Withdraw from the engagement
- Seek legal advice

Where law or regulation does not preclude the publication of a prospectus with a modified opinion the practitioner should include a modified opinion in accordance with HKSAE 3000.

3.3.3 Emphasis of matter

An emphasis of matter paragraph may be added to draw users' attention to a matter presented or disclosed in the pro forma financial information or the accompanying notes.

3.4 Accountants' reports on pro forma financial information in investment circulars

Under HKSIR 300 *Accountants' Reports on Pro Forma Financial Information in Investment Circulars*, reporting accountants should issue a report containing **a clear expression of opinion** on the *pro forma* financial information. This was updated in April 2013 to reflect the fact that it will be superseded by HKSAE 3420 for reports dated on or after 1 July 2013.

Pro forma financial information is included in the **investment circular** to show information about the transaction that is subject to investment circular by showing how it might have affected financial information of the **issuer if the transactions** had been undertaken at the commencement of the financial period used for the illustration.

In the engagement to report on *pro forma* financial information in the investment circular, the reporting accountant should comply with HKSIR 300, HKSQC 1 (Clarified) and any relevant HKSAs, HKAEs and in particular, HKSA 220 (Clarified).

Reporting accountants should obtain **sufficient appropriate evidence** to form a basis for their opinion on the pro forma financial information.

4 Preliminary announcement of annual results

Topic highlights

The preliminary announcement of annual results must be agreed with the auditors before being published.

4.1 Guidance for auditors

Practice Note (PN) 730 *Guidance for Auditors Regarding Preliminary Announcements of Annual Results* is the first public communication of listed entities' full year results and year-end financial position.

The directors have obligations under the Listing Rules that the preliminary announcement of results for the financial year shall have been agreed with the issuer's auditors before being published.

PN 730 dictates the auditor's procedures and reporting the outcome of such procedures to the directors. Auditors should perform an agreed-upon procedures engagement.

The listed company is also required to provide additional information to accompany its preliminary announcement of results. Auditors are not required to report on the additional information to accompany the preliminary announcement of results.

5 Comfort letters and due diligence meetings on financial and non-financial information

Topic highlights

HKSIR 400 has recently been revised. Negative assurance may now be given in specific circumstances.

5.1 Comfort letters and due diligence meetings

Reflecting the increasing trend in the globalisation of capital market transactions HKSIR 400 *Comfort Letters and Due Diligence Meetings on Financial and Non-Financial Information* was revised in October 2011 to be more closely in line with international practices. The new standard is effective for comfort letters and due diligence meetings in respect of investment circulars dated on or after 1 January 2012.

One of the most significant changes is that a limited assurance approach, commonly referred to as negative assurance, is now permitted when reporting on subsequent changes. Previously, the reporting was done in the form of agreed-upon procedures.

According to previous HKSIR 400, **no assurance is expressed** in a comfort letter or due diligence meeting on financial or non-financial information. However under the revised HKSIR, it can now be an assurance engagement.

HKSIR 400 requires that, in providing a comfort letter and formulating responses to questions asked by sponsors, reporting accountants should note that:

- **only the sponsors** can determine what is sufficient for a reasonable due diligence investigation
- the sponsors can rely on any statements made by the reporting accountant
- the reporting accountant needs to possess adequate knowledge on the subject matters before making any statements and act with due care and with an objective mind
- there must be supporting evidence to support the statements made.

(The standard was also revised in December 2012 but these changes do not change the basic principles above.)

6 Engagements to report on summary financial statements

Topic highlights

The auditor will only accept the engagement when the auditor has also been engaged to conduct an audit of the financial statements from which the summary is derived.

6.1 Objectives

HKSA 810 (Clarified) *Engagements to Report on Summary Financial Statements* governs the engagement to report on summary financial statements and is effective for engagements for periods beginning on or after 15 December 2009. This standard has been revised and is effective upon issue.

The objectives of the standard are to assist auditors to determine whether it is appropriate to accept the engagement to report on summary financial statements and to form an opinion on the summary financial statements, based on an evaluation of the conclusion drawn from the evidence obtained to express clearly that opinion through a written report that also describes the basis for that opinion.

HKSA 810.4

Key terms

Applied criteria. The criteria applied by management in the preparation of the summary financial statements.

Summary financial statements. Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.

6.2 Engagement acceptance

HKSA 810, 5-6

The auditor shall accept an engagement to report on summary financial statements in accordance with this HKSA only when the auditor has been engaged to conduct an audit in accordance with HKSAs of the financial statements from which the summary financial statements are derived.

Before accepting an engagement to report on summary financial statements, the auditor shall:

(a) determine whether the applied criteria are acceptable

(b) obtain the agreement of management that it acknowledges and understands its responsibility:

  (i) for the preparation of the summary financial statements in accordance with the applied criteria

  (ii) to make the audited financial statements available to the intended users of the summary financial statements without undue difficulty

  (iii) to include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them

(c) agree with management the form of opinion to be expressed on the summary financial statements.

The auditor shall not accept the engagement to report on the summary financial statements, if the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management that it acknowledges and understands its responsibilities as described above.

6.3 Engagement procedures

HKSA810.8

The auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary financial statements:

(a) Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.

(b) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:

  (i) from whom or where the audited financial statements are available; or

  (ii) the law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.

(c) Evaluate whether the summary financial statements adequately disclose the applied criteria.

(d) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be recalculated from the related information in the audited financial statements.

(e) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.

(f) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.

(g) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.

6.4 Form of opinion

HKSA 810.9-10

When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases:

(a) The summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with (the applied criteria); or

(b) The summary financial statements are a fair summary of the audited financial statements, in accordance with (the applied criteria).

If law or regulation prescribes the wording of the opinion on summary financial statements differently, the auditor shall:

(a) apply further procedures necessary to enable the auditor to express the prescribed opinion; and

(b) evaluate whether users of the summary financial statements might misunderstand the auditor's opinion on the summary financial statements and, if so, whether additional explanation in the auditor's report on the summary financial statements can mitigate possible misunderstanding. The auditor shall not accept an engagement where possible mitigation of misunderstandings cannot be carried out.

6.5 Report date

HKSA 810.16

The auditor's report on the summary financial statements may be dated later than the date of the auditor's report on the audited financial statements. The report must state when the summary does not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements that may require adjustment of, or disclosure in, the audited financial statements. Therefore, subsequent event review under HKSA 560 (Clarified) is still required to be performed.

6.6 Elements of the auditor's report

HKSA 810.14

The auditor's report on summary financial statements shall include the following elements:

(a) A title clearly indicating it as the report of an independent auditor.

(b) An addressee – the auditor shall evaluate the appropriateness of using a different addressee if the addressee of the summary financial statements is not the same as the addressee of the auditor's report on the audited financial statements.

(c) An introductory paragraph that:

 (i) identifies the summary financial statements on which the auditor is reporting, including the title of each statement included in the summary financial statements;

 (ii) identifies the audited financial statements;

(iii) refers to the auditor's report on the audited financial statements, the date of that report, and the fact that an unmodified opinion is expressed on the audited financial statements;

(iv) if the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, states that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements; and

(v) includes a statement indicates that the summary financial statements do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements, and that reading the summary financial statements is not a substitute for reading the audited financial statements.

(d) A description of management's responsibility for the summary financial statements, explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria.

(e) A statement that the auditor is responsible for expressing an opinion on the summary financial statements based on the procedures required by this HKSA.

(f) A paragraph clearly expressing an opinion.

(g) The auditor's signature.

(h) The date of the auditor's report. The auditor shall date the auditor's report on the summary financial statements no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion or the date of the auditor's report on the audited financial statements.

(i) The auditor's address.

6.7 Emphasis of matter and modified opinions

6.7.1 Emphasis of matter paragraph

HKSA 810.17-20

When the auditor's report on the audited financial statements contains a qualified opinion, an **emphasis of matter paragraph**, or an other matter paragraph, but the auditor is satisfied that the summary financial statements are **consistent**, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall:

(a) state that the auditor's report on the audited financial statements contains a qualified opinion, an emphasis of matter paragraph, or an other matter paragraph; and

(b) describe:

(i) the basis for the qualified opinion on the audited financial statements, and that qualified opinion; or the emphasis of matter or the other matter paragraph in the auditor's report on the audited financial statements; and

(ii) the effect thereof on the summary financial statements, if any.

6.7.2 Adverse opinion or disclaimer of opinion

When the auditor's report on the audited financial statements contains an **adverse opinion or a disclaimer of opinion**, the auditor's report on the summary financial statements shall:

(a) state that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;

(b) describe the basis for that adverse opinion or disclaimer of opinion; and

(c) state that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express an opinion on the summary financial statements.

If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.

6.7.3 Restriction on distribution or use or alerting readers to the basis of accounting

The auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements when distribution or use of the auditor's report on the audited financial statements is restricted, or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework.

6.8 Comparatives and supplementary information

HKSA 810.21-22

When the summary financial statements do not contain comparatives but the audited financial statements contain such comparatives, the auditor shall determine the effect of an unreasonable omission on the auditor's report on the audited financial statements.

If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that requires the auditor to include in the auditor's report on the audited financial statements.

The auditor shall evaluate whether any **unaudited supplementary information** presented with the summary financial statements is clearly differentiated from the summary financial statements.

For any unaudited supplementary information presented with the summary financial statements that is **not clearly differentiated from the summary financial statements**, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report.

For any other information included in a document containing the summary financial statements, auditors should read the information and consider the inconsistencies.

6.9 Auditor association

HKSA 810.25

The auditor shall request **management to include the auditor's report** if they become aware of any document containing the summary financial statements on which they have reported but where management does not intend to include the related auditor's report. If management refuses, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

When auditors are engaged to report on the summary financial statements and the entity plans to make a statement in a document that refers to the auditor, the auditor should be satisfied that the reference to the auditor is made in the context of the auditor's report on the audited financial statements and the statement does not give the impression that the auditor has reported on the summary financial statements.

7 Audit of financial statements prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard (SME-FRS)

PN 900 (Clarified) *Audit of financial statements prepared in accordance with the Small and Medium-sized Entity Financial Reporting Standard* 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 Practice Note (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 s. 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 s. 141D of the Companies Ordinance

S141D of the Companies Ordinance exempts certain private companies from complying with the **full disclosure requirements** of the 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

PN900.9 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.

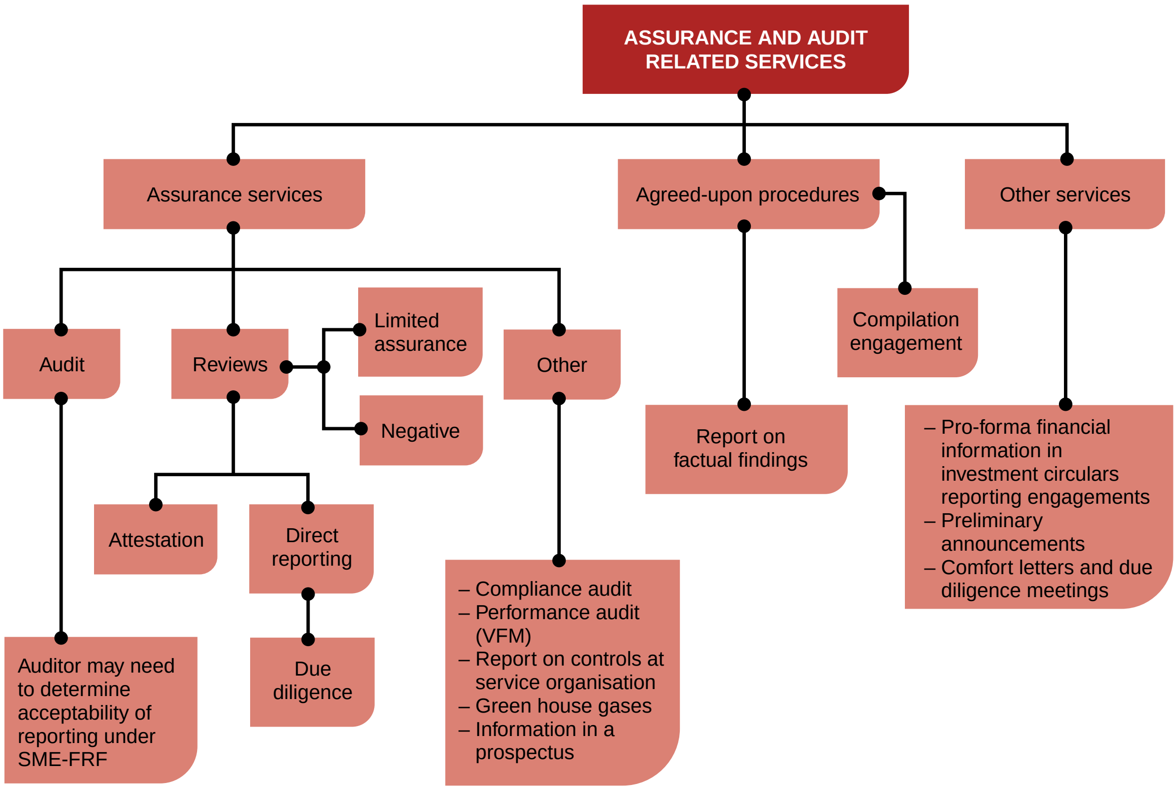
For a company incorporated in Hong Kong applying s. 141D, in addition to carrying out the audit procedures required by HKSAs, the auditor would ensure that:

(a) the company is entitled to take advantage of the exemptions permitted under s. 141D(3)

(b) the shareholders have entered into a new unanimous written agreement for the particular financial year under review; and

(c) the statement of financial position and accompanying notes contain the information required under the Eleventh Schedule of the Companies Ordinance.

Topic recap


ASSURANCE AND AUDIT RELATED SERVICES
Assurance services
Agreed-upon procedures
Other services
Audit
Reviews
Limited assurance
Negative
Other
Compilation engagement
Report on factual findings
– Pro-forma financial information in investment circulars reporting engagements
– Preliminary announcements
– Comfort letters and due diligence meetings
Attestation
Direct reporting
Due diligence
– Compliance audit
– Performance audit (VFM)
– Report on controls at service organisation
– Green house gases
– Information in a prospectus
Auditor may need to determine acceptability of reporting under SME-FRF

Answers to self-test questions

Answer 1

As per HKSRE 2410, the objective of a review of an interim financial report is to enable the auditor to express a conclusion whether anything has come to his attention that causes him to believe that the interim financial report is not prepared, in all material respects, in accordance with HKAS 34 *Interim Financial Reporting*.

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial report is free from material misstatement. A review provides limited assurance.

A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review may bring significant matters affecting the interim financial report to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

Answer 2

The Report of Factual Findings issued by the practising certified public accountant for the purpose of Capital Investment Entrant Scheme would likely to be within the scope of HKSRS 4400 *Engagements to Perform Agreed-upon Procedures Regarding Financial Information*.

In general, the practising certified public accountant should comply with the Code of Ethics for Professional Accountants; and conduct the engagement in accordance with HKSRS 4400 and any specific terms of the engagement.

The objective of such an agreed-upon procedures engagement is for the practising certified public accountant to carry out procedures of an audit nature to which the practising certified public accountant and the applicant and the relevant government agency have agreed and to report on factual findings.

Since the practising certified public accountant simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed.

Instead, users of the report (mainly officers of the relevant government department) assess for themselves the procedures and findings reported by the practising certified public accountant and draw their own conclusions from the auditor's work.

To ensure that users of the report understand the nature of the engagement, the practising certified public accountant should state in the report of factual findings that the procedures performed do not constitute an assurance engagement performed in accordance with Hong Kong assurance standards, and, as such, no assurance is expressed.

Given that the Report of Factual Findings is for specific purposes, the practising certified public accountant should also restrict the use and distribution of the report of factual findings only to those related to the specific purposes.

For example, in the engagement letter and in the report, the practising certified public accountant may restrict distribution of the report of factual findings to the relevant government department(s).

Exam practice

Micro

36 minutes

Micro is a small company which is not required to have a compulsory external audit. There are only three shareholders, all of whom are on the company's board of directors. In the past the company has not had an external audit because none of the interested parties have felt it necessary to have one on a voluntary basis.

Micro has approached its bank and asked for a substantial loan in order to fund an expansion. The bank has indicated that the application would be more likely to succeed if it was accompanied by an independent accountant's report that indicated that the statements gave a true and fair view and were a suitable basis for the loan decision. The directors of Micro have asked your firm to provide this report.

Required

(a) Identify the difficulties that might arise in planning and conducting the work requested by Micro. **(12 marks)**

(b) Explain the extent to which you might be liable to the bank for any alleged errors in the financial statements, assuming that you prepared the report requested by Micro. **(8 marks)**

(Total = 20 marks)

Part F

Computerised business systems

Computerised business systems are common nowadays when internet technology and culture developed rapidly over the last two decades. Virtually no assurance process could be completed without a proper consideration and assessment of the computerised business systems involved. Students will learn from this Part the impact and relationship of computerised business systems and the assurance process.

chapter 20

Information technology

Topic list

Learning focus

Computers are vital to the functioning of the business.

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool. CAATs are an important tool in the audit and we examine the two main types of CAATs, audit software and test data.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
4.01	**Key features of a computerised business system**	3
4.01.01	Explain the characteristics of an entity operating a networked computer system	
4.01.02	Explain the characteristics of an entity operating with standalone PCs	
4.02	**Categories and types of controls**	3
4.02.01	State examples of controls in a computerised system	
4.02.02	Define and give examples of general and application controls	
4.03	**Impact of increasing use and share of ownership by accountants in corporate information system**	2
4.04	**Impact of e-commerce**	3
4.04.01	Recognise and discuss the importance of e-commerce to a business	
4.04.02	Identify and explain the effect of e-commerce on the auditor's risk assessment and audit approach	
4.04.03	Identify the knowledge and skills required to audit an entity's e-commerce activities	
4.05	**Opportunities and threats to corporate information system including capabilities in data treatment and analysis, data integrity, system security and issues in access restriction, and business contingency/continuity**	2
4.06	**Risk and control framework**	3
4.06.01	Explain the audit problems of an entity operating a networked computer system	
4.06.02	Explain the audit problems of an entity operating with standalone PCs	
4.07	**Internal audit**	3
4.07.01	Explain the ways in which internal audit is of particular significance in a computerised accounting system	
4.07.02	Identify the procedures that an auditor may have to undertake to assess the role of internal audit	
4.08	**System change processes**	2
4.08.01	Explain the potential impact on the auditor where an entity changes its computerised system	
4.09	**Risk assessment and evaluation of IT processes**	2
4.09.01	Identify what factors the auditor may need to consider in assessing the audit risk of a computerised environment	
4.09.02	Describe the use of computer-assisted audit techniques (CAAT) in an audit	

1 Information technology audit

Topic highlights

The purpose of the information technology ("IT") audit is to evaluate the system's internal control design and effectiveness. This includes, but is not limited to, efficiency and security protocols, development processes, and IT governance or oversight. The objectives and requirements around tests of controls apply to the audit of internal controls in a computerised environment.

Most entities now use IT systems to carry out their businesses and to process, maintain and report essential information to stakeholders. This means that many of the controls which the directors are required to put into place to safeguard the assets of the shareholders are incorporated into computer systems.

As a consequence, the reliability of computerised data and of the systems that process, maintain and report these data are a major concern to audit.

Key terms

Information technology audit, or **information systems audit**, is an examination of the management controls within an information technology (IT) infrastructure. They were also formerly called "**electronic data processing** (EDP) audits".

An information technology audit, or information systems audit is the **evaluation of obtained evidence** to determine if the information systems are **safeguarding assets**, maintaining **data integrity**, and **operating effectively** to achieve the organisation's goals or objectives. These reviews form part of a financial statement audit, but may also be performed in conjunction with an internal audit, or other form of attestation engagement.

In Chapter 11, we looked at the evaluation of internal controls and tests of controls. You should be familiar with the requirements of HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* and HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risk* in this area. The same objectives and requirements apply to the audit of IT systems. The principles in the two HKSAs are the same whether you are working in an IT environment or not.

Auditing in a computerised environment requires the auditors to consider several factors:

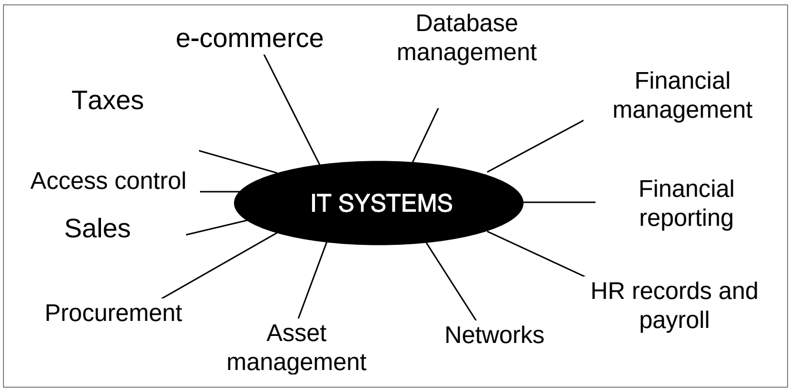
- How the entity's computerised systems impact its business and the financial statements
- To what extent the computerised processes are formalised and the relevant controls are documented
- To what extent the auditor can rely on the data and processes generated by the computerised systems
- Whether the auditors will make use of CAATs
- Whether the engagement team has the required skills and experience to carry out the audit
- To what extent the audit documentation will be kept in electronic form, and how.

2 The IT environment

Topic highlights

In performing a risk assessment, it is important for auditors to gain an understanding of how computerised business systems have been implemented, the extent to which they are integrated into the company's business, and how such systems impact the financial statements.

The diagram below shows the various areas of IT in the entity which may interest auditors.



In the following sections, we will introduce the process of developing an information system, and look at three applications of IT which are particularly relevant to audit: financial reporting systems, e-commerce and intranets and extranets.

2.1 Implementation of new IT systems

Implementing a new IT system often requires significant expenditure, and brings about fundamental change to a company's processes. Therefore, effective planning before the implementation and risk management procedures throughout the implementation process are essential.

Before implementing a new IT system, the company must evaluate its business needs and future strategy to ensure the new system is aligned with the business's requirements. This will also drive the following decisions:

- Should bespoke software be acquired, or will an off-the-shelf package suffice?
- How will the system be rolled out across the organisation?

2.1.1 System development process

The table below illustrates a system development life cycle.

Stage	Comment
Project definition	This involves an investigation and analysis of the company's business and reporting needs to decide if a new or modified information system is required. If a new project is identified, its objectives, scope and project plan are developed.
Feasibility study	This involves reviewing the existing system and identifying a range of possible alternative solutions. A feasible (technical, operational, economic, social) solution will be selected – or a decision made not to proceed.

Stage	Comment
Design	The logical and physical design specifications are produced in a detailed specification of the new system.
Programming or software selection	If bespoke software is to be produced, analysts work with programmers to prepare program specifications and then the programs themselves. If off-the-shelf software is suitable, packages are evaluated (perhaps in a report) and selected.
Installation	Steps are taken to put the system into operation. Testing, file conversion and user training are carried out. A formal conversion plan is developed.
Post-implementation	The system is used and evaluated. A formal post-implementation audit determines how well the system has met its objectives and whether any modifications are required.

2.1.2 Bespoke or off-the-shelf?

The simplest and cheapest way to source a software is to buy an off-the shelf solution, which has been designed for a wide range of users. However, the company must consider whether this sufficiently meets the business's needs.

The table below gives a comparison between bespoke and off-the-shelf software.

Off-the-shelf software	Bespoke software
A ready-made package will almost certainly be cheaper because it is mass-produced.	The cost is considerable when compared with a ready-made package.
The software is likely to have been written by software specialists and so should be of a high quality.	As the software is being developed from scratch, there is a risk that the package may not perform as intended.
A successful package will be continually updated by the software manufacturer.	Continued maintenance and support needs to be planned by the company, and is likely to cost more than with off-the-shelf software.
A well-established package should be relatively free of bugs.	There is a greater chance of "bugs". Widely used off-the-shelf software is more likely to have had bugs identified and removed.
Good packages are well-documented, with in-built control procedures.	Documentation and control procedures need to be separately designed and implemented, to varying degrees of reliability.
Some standard packages can be customised to a limited extent.	If it is well-written, the software should meet the organisation's specific needs. The software can be tailored to be compatible with other existing systems being used within the entity.
The company is dependent on the supplier for maintenance of the package.	The software should be able to be updated and extended to meet future needs.
Competitors may well use the same package, removing any competitive advantage.	The software may be a source of competitive advantage.
Data and file structures are dictated by the package design.	Data and file structures may be chosen by the organisation.
The development time is likely to be very short.	Development will take longer than purchasing ready-made software.

2.1.3 System conversion

Implementing a new information system is likely to entail some inevitable “teething problems”. Staff will need to be adequately trained to use the new system, data on the existing system will need to be transferred, and especially where the system is bespoke, a wide range of processes need to be built in to respond to all the different transactions that take place on a daily basis. The larger and more complex the company, the more it is likely to be at risk of teething problems – the impact of such problems are likely to be greater too.

Insufficient planning around system conversion can result in delays in processing which have a negative impact on customer and supplier relationships. Even more importantly in an audit context, it can lead to an increased risk of transactions being incorrectly recorded, data lost and fraud going undetected.

There are three main system conversion approaches:

Approach	Comment
Pilot system approach	The company implements the new system in a few pilot locations/ business units, before rolling it out across the entire organisation. The risks of system failure are thus reduced to the pilot sites.
Phased operation approach	The company implements the new system in stages, for example one specific module after another. This reduces the risks of system failure to the specific modules implemented.
Parallel operation approach	The company implements the new system across the entire organisation from the start, but maintains the existing system during the transition period in case of disruptions. This is the most costly approach, but entails lowest risks in terms of data.

Which of the approaches above are most suitable to a company depends on the nature and size of the company’s business, as well as its resources.

In gaining an understanding of the company’s business systems, the auditor must understand how the system’s software has been designed and implemented. The nature of the software (for example, whether it is a bespoke or an off-the-shelf solution) can impact the auditor’s assessment of the risk of material misstatement.

If a new computerised system has been implemented, it is important that the auditor obtains an understanding of the system development process and how the changes to the system affect the financial statements. The increased risk of fraud and errors during the transition period has to be considered. In some circumstances, it may be appropriate to adopt a more substantive approach to audit.

2.2 Financial reporting systems

Key terms

The **information system relevant to financial reporting** is a component of internal control that includes the financial reporting system. It consists of the procedures and records established to initiate, record, process and report the entity's transactions, and to maintain accountability for the related assets, liabilities and equity.

Financial reporting systems include the following:

- Records of transactions, such as sales, purchases and expenses
- Maintenance of the general ledger
- Creation and documentation of invoices
- Settlement of payables balances and record of payment
- Receivables management and records
- Making of journal entries
- Maintenance of other events and conditions relevant to the financial statements (for example, depreciation of non-current assets)
- Records of significant accounting estimates and disclosures
- Controls around the recording of transactions, journal entries and adjustments

Even though financial reporting systems in most companies are computerised now, they remain subject to manual input to a large extent. For example, while sales records may be fed automatically through from the point of sales to the general ledger and the receivables account, the actual transaction is input manually. The reconciliation of the general ledger and the receivables account also has to be reviewed manually, also the receivables balances.

The reliability of financial reporting systems therefore depends largely on the integrity of manual input. In-built computerised controls can help, but even these can be overridden manually.

The auditor needs to understand the scope of the computerised financial reporting system and the extent of the in-built controls, in order to assess the risk of material misstatement in the financial statements.

2.3 E-commerce

Key terms

Electronic data interchange (EDI) is a form of computer to computer data transfer. Information can be transferred in electronic form, avoiding the need for the information to be re-inputted somewhere else.

Electronic commerce (e-commerce) means conducting business electronically via a communications link.

E-commerce has developed significantly over recent years, and continues to grow.

A business can engage in "e-commerce" to a great or small degree. The greater the involvement, the more the risk associated with the involvement. The extent of involvement is explored in the following table.

Involvement	Risk
Information provision: A website can be used as a marketing device, to provide information to potential customers, and to enable them to request further information through an e-mail link.	LOW
Transactions with existing customers. Existing customers can be given the opportunity to track current contracts or initiate others over the website.	
Access to new customers. A website can be used as a place where new customers may initiate transactions with the company.	
New business model. A website can be used to diversify into specific web-based products, for example, items that are "downloadable".	HIGH

2.3.1 Security

The issue of security in e-commerce is extremely important. It is important for the business as fraudulent or bogus transactions could have a serious negative impact. It is important for the customer, particularly a private consumer, who is inputting sensitive personal data.

Information is secure to the extent that the requirements for its authorisation, authenticity, confidentiality, integrity, non-repudiation and availability have been satisfied.

2.3.2 Transaction integrity

In particular, controls over **transaction integrity** will be of great importance, as the system will capture transactions and automatically process them. It is also important that the transaction is **processed completely** through the accounting system.

Hence the assurance services over the **design and operation of systems** will be of great importance.

2.3.3 A question of trust

A key problem with e-commerce is one of **trust**. In most cultures, consumers grant their trust to business parties that have a close **physical presence**: buildings, facilities and people to talk to. On the Internet these familiar elements are simply not there. The seller's reputation, the size of his business, and the level of customisation in product and service also engender trust.

Internet merchants need to elicit consumer trust when the level of **perceived risk** in a transaction is high. However, research has found that once consumers have built up trust in an Internet merchant such concerns are reduced.

Internet merchants need to address issues such as fear of **invasion of privacy** and abuse of customer information (about their **credit cards**, for example) because they stop people even considering the Internet as a shopping medium.

The parties involved in e-commerce need to have confidence that any communication sent gets to its target destination **unchanged**, and **without being read by anyone else**. This is achieved by **encryption**.

2.3.4 Web assurance

Customers are rightly concerned about the following when making purchases on-line:

- processing of the transaction
- use of the personal information that must be given to complete the sale; and
- poor business practices by the company (late delivery/errors in orders etc).

Web assurance seeks to remove this barrier by providing assurance to the users of the service. An example of an assurance service developed in relation to e-commerce is WebTrust.

WebTrust examines the assertions of the company relating to the concerns above, and seeks evidence as to whether what they say about their service is true, and whether their systems comply with pre-determined criteria.

The outcome of the exercise is that if the accountant has assurance that the systems comply and the representations made about the service is fair, the website can be WebTrust accredited.

Self-test question 1

Electronic commerce (e-commerce), has increased rapidly. The growth of e-commerce has significant effects on an entity's traditional business environment and significant impact on the audit of financial statements. The auditors' knowledge of e-commerce is fundamental to the assessment of its significance for the entity's business activities and any effect on audit risk.

Required

What business risks does a stockbroking company face by introducing e-securities trading services to its customers such that customers can process their buying and selling transactions through the Internet? What internal controls can be implemented to mitigate these risks?

(The answer is at the end of the chapter)

2.4 Intranets and extranets

2.4.1 Intranets

Intranet is the generic term for a **collection of private computer networks** within an entity. An intranet uses **network technologies** as a tool to facilitate communication between people or workgroups to improve the data sharing capability and overall knowledge base of an entity's employees.

Intranets utilise standard network hardware and software technologies like Ethernet, WiFi, TCP/IP, Web browsers and Web servers. An entity's intranet typically includes Internet access but is firewalled, so that its computers cannot be reached directly from the outside. A simple intranet consists of an internal email system and perhaps a message board service. More sophisticated intranets include websites and databases containing company news, forms, and personnel information. Besides email and groupware applications, an intranet generally incorporates internal websites, documents, and/or databases.

2.4.2 Extranet

A common extension to intranets, called **extranets**, opens this firewall to provide controlled access to outsiders.

An extranet is a networking environment set up so that a customer, supplier, or external consultant outside the company can access data and/or applications inside the entity's network.

Extranet access from the Internet can be controlled through various tools such as password or username specific. In other words, areas of the extranet will be available according to password credentials. This limits users to extranet pages relevant to the business they might be conducting, while keeping other areas of the extranet private and secure.

Risks associated with extranet

Use of extranets can pose the following risks:

(a) The more people can enter into an entity's network, the more possibility for the wrong people to get in and do damage to internal systems and data.

(b) The risks of computer viruses and other malicious code which can attack information and information systems.

(c) It allows unauthorised users to exploit sensitive information of the entity.

(d) If connecting parties to the extranet have inadequate access controls or have a lack of understanding of extranet security policies and requirements, they could expose the interconnected networks to penetration.

Security measures must be identified and implemented to mitigate the risks and these measures must address the changing and evolving security risks of the extranet.

3 The IT audit process

Topic highlights

The audit of computerised business systems follows the same process as a standard audit, from gaining an understanding of the environment and carrying out a risk assessment to performing further audit procedures to support the audit conclusion.

In auditing a computerised system, the auditor may audit **around** a computer, or audit **through** a computer.

3.1 Steps in the IT audit process

The auditor must **plan and conduct** the audit to ensure audit risk (the risk of reaching an incorrect conclusion based on the audit findings) will be limited to an acceptable level. If the following process looks familiar, this is because the IT audit process is the same as the audit planning and risk assessment processes an auditor would normally carry out.

1 **Obtain an understanding of the organisation and its IT environment:** This helps the auditor to assess the risk of material misstatement/deficiency and to set the scope of the audit. The auditor's understanding should include information on the nature of the entity, management, governance, objectives and strategies, and business processes.

2 **Evaluate the operating effectiveness of IT controls and identify risks that may result in material misstatements:** The auditor must evaluate an organisation's business risks which may lead to material misstatements.

3 **Evaluate the organisation's response to those risks:** The organisation's response (or lack thereof) to any business risks will impact the auditor's assessed level of audit risk.

4 **Assess the risk of material misstatement:** Based on the knowledge obtained in evaluating the organisation's responses to business risks, the auditor then assesses the risk of material misstatements and determines specific audit procedures that are necessary based on that risk assessment.

5 **Respond to the assessed risks of material misstatement:** Based on the conclusions drawn from the risk assessment, the auditor performs further audit procedures to obtain sufficient appropriate audit evidence on which to base the audit opinion. This may include the use of computer-assisted audit techniques.

3.2 Audit methodology

After completing the preliminary evaluation of the computer systems, the auditor has to determine the **appropriate audit approach**: a substantive approach or a combined approach.

A substantive approach is usually adopted when the auditor concludes that there are deficiencies in the internal control system, which means that the internal controls cannot be relied upon to provide sufficient appropriate audit evidence. The further audit procedures will therefore focus on tests of details and substantive analytical procedures.

A combined approach is likely to be adopted when the auditor concludes that the internal controls can be relied upon. Therefore, tests of controls can be performed in conjunction with substantive procedures (tests of details and substantive analytical procedures) to provide sufficient appropriate audit evidence.

Remember, no matter how reliable the internal controls are assessed to be, the auditors are always required to perform substantive procedures on material items.

3.3 Audit techniques

Audits can be carried out either **around** the computer, or **through** the computer.

3.3.1 Auditing around the computer

The auditor does not look at the specific workings of the system itself, but focuses instead on testing inputs and outputs.

A sample of inputs will be checked to outputs, and vice versa. If they prove to be accurate and valid, it is assumed that the system of controls is effective and that the system is operating properly.

The main advantage of auditing around the computer is that it requires very little technical expertise. However, this method is only suitable if there is a clear audit trail within the system, the system is relatively simple, and up to date documentation exists about how the system works.

3.3.2 Auditing through the computer

The auditor directly tests the controls within the system itself. This requires more technical expertise and knowledge in computerised systems.

This method involves examining the detailed processing routines of the computer, to determine whether the controls in the system are adequate, and whether the system is processing the data correctly and completely. It will often be necessary to employ computer-assisted audit techniques (discussed below).

Auditors customarily audit "through the computer".

Here are some typical steps in auditing through the computer.

(i) **Collecting and processing a set of test data** that reflects all the variants of data and errors which can arise in an application system at different times.

(ii) Using **integrated test facilities**, built into the system by the auditee to help the auditor in his requirements as one of the users of the system

(iii) Simulating the entity's application programs using **audit software** to verify the results of processing.

(iv) **Reviewing program listings** periodically to see that there are no unauthorised alterations to the programs.

(v) Using **either commercial software or in-house developed programs** to interrogate and retrieve data applying selection criteria and to perform calculations and extracting samples of data from the entity's database/files, using sampling techniques, for post analysis and review. The nature of data and type of analysis required determine what technique is to be employed. The auditor should give the sample size and design.

We will look at audit software and test data in further detail in the next section.

3.4 Audit requirements

The specific requirements of the audit must be agreed with the client, to ensure that the system can be audited in an effective and efficient manner. An audit trail has to be maintained to enable tracing an item from input through to its final destination and break up a result into its constituent parts.

In addition, auditors may have to use audit software or test data for the efficient execution of their audit. They have, therefore, to make reasonable requests for the access to copies of system data files, report generators and processing time.

Before considering the audit requirements for a system being developed, the auditor should have a knowledge of the currently existing system and should keep in mind:

(i) Weakness in the current system affecting the audit approach

(ii) Features in the existing system, which are relied on to provide an effective audit, that should be retained in the new system and

(iii) Additional facilities, not currently provided, which would assist the audit of the new system.

Audit of an application system which is operational involves verification of input/output controls, processing controls and audit trail. Evidence may be obtained on the following points in the course of audit to come to a reasonable conclusion regarding existence of controls and their adequacy.

3.5 Audit trail

Key term

An **audit trail** (also known as an **audit log**) is a chronological record of procedures in an information system which provides documentary evidence of the activities which have taken place in that system.

The auditor reviews the audit trail to obtain sufficient appropriate evidence regarding the reliability and integrity of the application system.

To achieve this, the audit trail should contain enough information to allow management, the auditor and the user to:

(i) recreate processing action

(ii) verify summary totals and

(iii) trace the sources of intentional and unintentional errors.

The audit trail **should include** the following information:

(i) **System information** including start up time, stop time, restarts, recovery etc

(ii) **Transaction information** including input items which change the database, control totals and rejected items (relevant to database applications)

(iii) **Communication information** including terminal log-on/off, password use, security violation, network changes and transmission statistics

If the design of the computer system does not provide for adequate audit trail this should be brought out in audit review, highlighting control deficiencies in the system. Apart from errors that might creep into the system, such control deficiencies may give rise to risks of fraud.

4 Controls in a computerised environment

Topic highlights

The overall audit objective in reviewing the general controls is to ensure that the controls and procedures are adequate to provide secure, effective and efficient day-to-day operation of the computer facilities.

Application controls are particular to an application and may have a direct impact on the processing of individual transactions and pertain to specific computer applications.

We have already looked at internal controls, and more specifically controls in a computer information system, in Chapter 11. Internal controls reflect the policies, procedures, practices and organisational structures designed to provide reasonable assurance that objectives will be achieved. The controls in a computerised system ensure effectiveness and efficiency of operations, reliability of financial reporting and compliance with the rules and regulations.

You should already be familiar with the two types of internal controls in a computerised system: **general controls and application controls**. Please refer back to Chapter 11 Section 4 for revision if necessary.

Auditors can gain an understanding of how the controls operate by:

- **inquiry**: asking management or staff
- **observation**: watching staff operate the system, and
- **inspection**: reviewing documentation produced by the system.

Remember, the extent of the procedures auditors perform in order to assess these controls depends upon their previous knowledge and experience of the information system, and the results of the risk assessment procedures already carried out.

4.1 General controls

As we saw in Chapter 11 Section 4, the overall audit objective in reviewing the general controls is to ensure that the controls and procedures are adequate to provide secure, effective and efficient day-to-day operation of the computer facilities.

In auditing general controls, the auditor verifies that:

(a) there is **segregation of duties** to reduce the risk of employee fraud or limitation of the scope of authority of any individual,

(b) there are **comprehensive written standards** and any changes are appropriately documented, and

(c) access to and use of computer terminals is properly authorised.

Remember, application controls may be useless when general controls are ineffective. Therefore, most auditors will review the design of general IT controls first, before reviewing the application controls.

General controls	Audit risk assessment procedures
Development of computer applications	Inspecting standards over system design, programming and documentation Performing full testing procedures using test data Observing approval by computer users and management Observing performance of procedures for evidence of segregation of duties

General controls	Audit risk assessment procedures
	Observing and inspecting documentation regarding installation procedures Inspecting training documentation
Prevention or detection of unauthorised changes to programs	Observing performance of procedures for evidence of segregation of duties Inspecting records of program changes Testing password protection of programs Inspecting physical access controls Inspecting program logs Inspecting evidence of virus checks on software Inquiring into back-up procedures Inspecting documentary evidence of control copies of programs being preserved and regularly compared with actual programs
Testing and documentation of program changes	Inspecting documentary evidence of testing procedures Inspecting documentation standards Inspecting evidence of approval of changes by computer users and management Inquiring into training of staff using programs
Controls to prevent wrong programs or files being used	Inquiring into and testing operation controls over programs Inquiring into and inspecting evidence of job scheduling
Controls to prevent unauthorised amendments to data files	Observing and testing password protection Observing existence of restricted access to authorised users Inspecting evidence of authorisation prior to processing (eg authorised data input forms)
Controls to ensure continuity of operation	Inquiring into and inspecting the storage of back-up copies of programs and data files off-site Inspecting the protection of equipment against fire and other hazards Inspecting evidence of disaster recovery procedures Inspecting documentary evidence of maintenance agreements and insurance
Controls over network security	Inspecting evidence of prior authorisation of the Network Administrator Inquiring into and observing restricted authorised access to communication and network systems Inspecting for existence of network diagnostic tools Inquiring into the existence of firewalls and inspecting evidence of firewall testing and maintenance Inquiring into and testing for evidence of data encryption for secure data transmission and controls over the identification of corrupt data.

4.2 Application controls

As we saw in Chapter 11, application controls are particular to an application and may have a direct impact on the processing of individual transactions and pertain to **specific computer applications**. They include controls that help to ensure the **proper authorisation, completeness, accuracy**, and validity of transactions, maintenance and other **types of data input**.

Application controls	Audit risk assessment procedures
Controls over **input**: **completeness**	Inquiring into and observing the operation of manual or programmed agreement of control totals Inspecting document counts Inspecting evidence of edit checks of input data Inspecting output of numerical sequence checks for evidence of manual follow-up of exception reports Inspecting evidence of one-for-one checking Inspecting programmed matching of input to an expected input control file Inspecting and observing documented procedures over resubmission of rejected controls
Controls over **input**: **accuracy**	Inquiring into and testing programs to check data fields on input transactions Inspecting evidence of manual scrutiny of output and reconciliation to source Inspecting agreement of control totals (manual/programmed)
Controls over **input**: **authorisation**	Inspecting for documentary evidence of manual checks
Controls over **processing**	Inspecting evidence of batch reconciliations Observing for existence of screen warnings can prevent people logging out before processing is complete Inspecting reports on unprocessed/ uncleared transactions (for example unpaid invoices)
Controls over **master files and standing data**	Inspecting evidence of one-to-one checking Inspecting evidence of cyclical reviews of all master files and standing data Inspecting record counts (number of documents processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions Observing controls over the deletion of accounts that have no current balance

Self-test question 2

In respect of the payments to distributors under various kinds of support funds for CEP's consumer electronics business, the management is considering to set up an integrated computer system. It has been suggested that the new system could link with the distributors' sales records on a real-time basis so as to ease the administration burdens and enhance the efficiency of operations.

Required

Identify and explain the specific controls which should be in place to ensure data and records are properly processed and maintained by the proposed integrated computer system.

(The answer is at the end of the chapter)

5 Computer-assisted audit techniques (CAATs)

Topic highlights

CAATs involve the use of computers for audit work but do not alter the overall scope or objective of the audit. They are particularly useful where there is no paper audit trail or in testing large samples of data. The two most commonly used CAATs are **audit software** and **test data**.

Key term

Computer-assisted audit techniques (CAATs) are the application of auditing procedures using the computer as an audit tool.

It is common to use a computer to help with auditing today. You probably use common CAATs all the time in your daily work without realising it.

(a) Some accounting systems allow data to be extracted into an ***ad hoc* report**.

(b) Simpler accounting systems allow data be exported directly into a **spreadsheet** package (sometimes using simple cut and paste facilities) and then analysed.

(c) **Searching** facilities are often included, making it much quicker to find an item than searching through print-outs by hand.

There is no change to the overall objectives and scope of an audit when it is conducted in a computerised environment.

CAATs improve the effectiveness and efficiency of auditing procedures and provide effective tests of control and substantive procedures where population and sample sizes are very large.

CAATs can be applied to a range of auditing procedures, such as the following:

- **Tests of details** of balances and transactions
- **Analytical review procedures**
- **Tests of computer information system controls** (including both general controls and application controls)
- **Sampling** programs to extract data for audit testing
- **Reperforming** calculations performed by the entity's accounting systems

The use of CAATs has grown as they have been shown to have a wide range of useful applications:

(a) Auditors can test program controls as well as the general internal controls associated with computers to obtain evidence of the existence and operation of those controls

(b) Larger sample sizes can be tested within time and resource constraints than would otherwise be possible

(c) Auditors can test transactions rather than the paper records of transactions which may be incorrect or missing

(d) CAATs are cost-effective in the long-term if the client does not change its systems involving modification to custom software or new software purchases

(e) Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased

(f) Tasks which are manually impossible can be carried out, for example, using the computer to trace key controls and processes where there is no visible audit trail.

However, the auditor will need to consider the following issues:

(a) The **time** and **costs** of setting up the related software

(b) **Training** for audit staff

(c) **Compatibility** of the CAAT software with the client's systems

(d) Risk of **corrupting/ losing live client data**

(e) Limited use – if data held on the system is limited

(f) The continued need for the auditor to apply **professional judgment**.

5.1 Audit software

Key term

Audit software is used by auditors to interrogate an entity's data and files during substantive testing. It may be generic audit software or custom audit software and will be used to carry out substantive procedures.

5.1.1 Types of software

There are two main types of audit software: generalised audit software and custom audit software.

Generalised audit software (*package programs)* allows auditors to:

(a) perform tests on an entity's computer files and databases, such as reading and extracting data from a client's systems for further testing

(b) select data that meets certain criteria in order to create populations and samples

(c) perform calculations on data, facilitating audit sampling and producing documents and reports

By automating these processes, the auditors are able to devote more resources to analysing and investigating the results and so increase their chance of detection of material misstatement.

Custom audit software (*purpose-written programs)* is written by auditors for specific tasks when generic audit software is unsuitable for the purpose. This may be based on the client's own software, modified as necessary, as this is more cost effective than creating new software from first principles.

Utility programs are used by an entity to perform common data processing functions, such as sorting, creating and printing files.

System management programs are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software.

The table below gives a range of examples of the use of audit software:

Audit software: applications
• Perform calculations and comparisons in analytical procedures • Sampling programs used to extract data for audit testing, eg select a sample of receivables for confirmation • Scan a file to ensure that all documents in a series have been accounted for or to search for large and unusual items • Compare data elements in different files for agreement (eg prices on sales invoices to authorised prices in master file) • Reperform calculations eg casting sales ledger • Prepare documents and reports eg produce receivables confirmation letters and monthly statements • Interrogation software, which accesses the client's data files • Comparison programs, which compare versions of a program • Interactive software for interrogation of online systems • Resident code software to review transactions as they are processed

Audit interrogation software is particularly appropriate during the substantive testing of balances and transactions. By automating procedures the auditors are able to **scrutinise large volumes of data** and **concentrate skilled manual resources on the investigation of results**, rather than on the extraction of information and selection of samples.

5.2 Test data

Key term

Test data techniques are used for tests of controls. By inputting a sample of transactions or other relevant data into an entity's computer system, and comparing the results obtained with pre-determined results, an auditor is able to check that the entity's systems are processing data in the correct way.

One way of checking whether a system is **processing** data correctly is to enter some valid test data and compare the results against what is expected to happen. Test data may also be used to establish whether the controls that prevent the processing of **invalid data** are working effectively. Invalid data might include, for example:

- A non-existent customer code
- A transaction worth an unreasonable amount
- A transaction which if processed would be in breach of authorisation limits such as customer credit limits.

There are three different ways to apply test data techniques:

(a) Test data may be used to test **specific controls** in computer programs, such as online passwords and data access controls.

(b) Test transactions may be selected from transactions already processed or created by the auditors to test **specific processing characteristics** of an entity's computer system. These transactions are usually processed separately from the entity's routine processing. This might include the testing of the processing of invalid data as discussed above.

(c) Test transactions may be used in an **integrated test facility**. This is where a "dummy" unit (perhaps a department or employee) is created, and to test transactions are input during the normal processing cycle.

One significant problem with test data is that it may cause an inadvertent corruption of data files which has to rectified. This may be difficult with modern real-time systems, which often have in-built (and much to be encouraged) controls to ensure that data once entered **cannot** be easily removed without leaving a trace.

Another problem with **test data** is that it only tests the operation of the system at **one point in time**. Also, auditors are testing only the controls in the programs being operated and which they know about.

These significant drawbacks have reduced the use of test data as a CAAT.

5.2.1 Embedded audit facilities

The results of using test data rely on the fact that the programs used to process it are the ones in general use for processing. If a member of the IT department commits fraud by substituting one version of the program that gives the correct results, purely for the duration of the test, and then replaces it with a version that siphoned off the entity's funds into his own bank account, the effect of test data is totally negated.

'**Embedded audit facilities**' prevent this type of fraudulent activity. An embedded facility consists of audit modules that are incorporated into the computer element of the entity's accounting system which allow a **continuous review** of the data recorded and the manner in which it is treated by the system.

The use of IT to produce reports adds complexity to the work of auditors. They need to ensure that:

(a) there is excellent version control over the reports produced: ie no-one relies a report that has been superseded

(b) the reports are protected from interference (sometimes called hacking)

(c) the auditors involved have sufficient IT expertise as they need to understand the systems, and how they work, as well as the overall objectives they are trying to achieve

5.3 Documentation

The standard of working paper documentation and retention procedures for a CAAT should be consistent with that for the audit as a whole.

5.4 Using CAATs in small entity IT environments

Small entities may create a particular set of difficulties in the use of CAATs. It is for the auditors to determine at the planning stage whether the use of CAATs will be effective in a small or medium-sized entity.

(a) The level of general controls may be less in a small entity so the auditors place less reliance on the system of internal control. As a result there will be more emphasis on tests of details of transactions and balances and analytical review procedures. This may make CAATs, particularly the use of audit software, particularly useful.

(b) For smaller volumes of data, manual methods for testing may be more cost effective.

(c) Auditors should bear in mind that a small entity may not have adequate technical support in-house, making the use of CAATs impracticable.

(d) Certain audit package programs may not operate on small stand-alone computers, thereby restricting the auditors' choice of CAATs. Sometimes, the entity's data files may be copied and processed on an alternative computer with obvious controls being necessary over the confidentiality and security of files.

Self-test question 3

ABC Limited is a wholesaler selling all types of tyres for motor vehicles and motor cycles. The company has a central warehouse from which the tyres are distributed throughout Hong Kong.

Inventory records are maintained by computer. All inventories are carried at invoice cost and are written down to net realisable value where there is a decline in inventory value.

In preparation of the year-end inventory count next month, ABC Limited has printed a count booking detailing the product code number, and the product description. The company personnel will record the quantity counted for each of the products listed in the count book. The information in the count book will be entered into the computer and processed against the current master file. The quantity on hand will be adjusted to reflect the actual count and count variance greater than $1,000 will be followed up. The final inventory listing will then be printed out.

The inventory records have the following fields:

- Product number
- Product description
- Quantity on hand
- Unit cost
- Total value
- Date of last purchase
- Supplier code
- Date of last sale
- Physical count variance

You are the auditor of ABC Limited. What specific procedures could be performed with the use of CAATs to verify ABC Limited's closing inventory?

(The answer is at the end of the chapter)

6 Control issues in small computer systems

Topic highlights

In stand-alone computer environments, one user tends to process many accounting application programs. The user is more likely to purchase **off-the-shelf software packages**. The PC environment is **less structured** than a centrally controlled IT environment, therefore controls are likely to be more informal. The available documentary evidence is likely to be limited.

6.1 Characteristics of small computer systems

In small entities it is common for the personal computer (PC) to constitute the entire computer-based accounting system. Stand-alone PCs can be operated by a single user or many users at different times, accessing the same or different programs on the same computer.

In stand-alone computer environments, one user tends to process many accounting application programs. The user is more likely to purchase **off-the-shelf software packages**. The PC environment is **less structured** than a centrally controlled IT environment, therefore controls are likely to be more informal. The available documentary evidence is likely to be limited.

In a PC environment, the effectiveness of controls depends largely on segregation of duties. This is less likely to be achieved in a small entity.

In a typical stand-alone PC environment, the level of general controls is **lower** than expected in a large-scale entity.

6.2 Internal controls in a small computer environment

As mentioned above, normally the controls that are used for large computer systems would not appear for PCs. In contrast, certain types of internal controls become more important because of the characteristics of stand-alone PCs and the environments in which they are used.

The following issues are likely to arise in a small computer environment:

(a) **Lack of segregation of duties**: The same person prepares the data, feeds it into the computer, supervises the processing and acts as end user. This lack of division of duties leads to enhanced opportunities for fraud.

(b) **Lack of control over users**: The PC terminals are readily available to any user, if access controls such as log in IDs and passwords are not in place.

(c) **Lack of control over alterations to programs**: PCs employ high level languages and a working knowledge can be grasped within a short time. There is a danger that programs might be altered without detection.

(d) **Lack of documentary evidence**: Manual controls may need to be implemented to ensure that transactions can only be processed when supported by an appropriate initiating document, and changes are reported and reviewed.

(e) **Lack of planning over acquisition and use of PCs**: Limited in-house expertise and lack of planning may result in unsuitable software packages being acquired.

Experienced and competent management, combined with effective policies and procedures for the acquisition, implementation, operation and maintenance of stand-alone PCs can enhance the overall **control environment**.

The following are some of the **typical internal controls** in a stand-alone PC environment:

(a) **Set up organisational policies and procedures** – on acquisition, implementation, operation and maintenance can enhance the overall control environment, ie passwords management, training, personal policies, software acquisition, data protection standards and virus protection

(b) **Physical protection for equipment** – locked rooms, alarm system, encryption of key files and other access controls

(c) **Physical protection for removable and non-removable media** – ie USB, CDs, external hard disks, remove media off-site

(d) **Program and data security** – using passwords, implementing access control package, removable storage media, using encryption and using hidden directories and files

(e) **Continuity of operations** – retain copies of the operating systems, programs and data in a secure location

6.3 Auditing in a small computer environment

In a stand-alone PC environment, the client may not implement sufficient controls to reduce the risks of undetected errors since it is neither practicable nor cost effective to do so. The auditor may find it more cost effective to concentrate audit work by **using substantive procedures** rather than analysing the general controls and application controls in details.

Auditors may use more extensive physical examination and confirmation of assets, more tests of transactions, larger sample sizes and greater use of computer-assisted audit techniques (CAATs). If the level of general controls appears adequate, the auditors may consider adopting a different approach, ie combined approach.

The auditor will also need to consider whether auditing around the computer or auditing through the computer is more appropriate. Given the simpler systems, it may be possible to audit around the computer. However, this is only appropriate if adequate documentation is in place and the auditor can place reliance on the effective operation of the system.

7 Specific external IT audit areas

7.1 Audit of the acquisition of computer facilities

The auditor has to review the adequacy of administrative procedures and controls used by the entity organisation when considering and deciding upon the acquisition of computer facilities. For this purpose, the auditor has to examine that:

(i) a **sound administrative structure** exists to produce a proper analysis of the requirements of computer facilities

(ii) the **acquisition procedures** are effective in producing a viable computing policy and strategy and

(iii) the **process of evaluation and selection** ensure that the requirements of the organisation are met in the most effective and efficient way.

7.2 Audit of system development

The audit objective of **system development controls** is to ascertain that procedures are adequate to ensure that the **development results** in well-documented computer systems incorporating adequate controls and meeting properly defined user requirements in an efficient manner.

There is also a need to examine the system testing and data transfer procedures as:

(i) inadequate system testing before line operation may result in the operation of a system which may not correctly process and record transactions; and

(ii) inadequate data transfer procedures may result in the relevant records being inaccurately and incompletely transferred from the old to the new system.

System development audits can be categorised into three general classes:

Monitoring audits	Design review audits	Post implementation audits
The auditor evaluates the project throughout the process to determine whether development is proceeding effectively. For example: whether milestones are being met, expenditure rates are as predicted, high quality documentation is being written, software conforms to established. technical standards, tests are being conducted as scheduled or evaluated as planned.	The objective is to determine whether the preliminary and detailed designs accurately reflect the functional data and systems specifications, and incorporate adequate internal controls.	Performed three to six months after the system becomes operational, this serves to evaluate whether the system meets requirements, is cost-effective and generally provides benefits predicted in project planning documents.

8 IT internal audit

Topic highlights

Technology plays an increasing critical role in the daily management of entities. Meanwhile unintentional data loss incidents and IT failures have increased due to both unintentional or intentional acts. In this IT environment, the role and importance of IT internal audit have grown drastically for maintaining the security of commercial data and the reputations of corporate institutions.

8.1 Detailed plan for the IT audit

The IT internal auditor should prepare a detailed plan of the audit and determine the scope of the audit activity as they are essential for ensuring that organisational risks are understood and addressed via the internal audit plan. However, often IT audit is delivered separately from an audit. Many IT audit tools deliver a structured approach to planning and focus the IT audit on the business and technological risks of the entity.

It is suggested that IT internal audit should be integrated into wider audit activity, for example, including Sarbanes-Oxley compliance. This is to ensure the independence and objectivity of IT internal auditors is not compromised by becoming involved in business and systems decision-making.

Recruiting the right staff with the right skills and experience is critical for successful delivery of an effective IT audit plan. This can be achieved by encouraging IT and non-IT auditors to work more closely together in the workplace.

Audit departments need to use automated tools more widely. It is believed that the most technically proficient staff can lead the way in enhancing the efficiency of the IT internal audit process through automation. Readily-available tools are most commonly used by IT internal audit staff.

8.2 Detailed plan: the IT audit

The following are some suggestions to improve effectiveness of IT audit:

(a) IT internal audit should seek to get closer to the business and to IT decision-makers. Professionals must demonstrate that business and technology risks are equally understood. Audit plans should be reviewed on a rolling or quarterly basis to help businesses respond more rapidly to change the risk.

(b) Align IT audit to other governance activities to benefit from scale and expertise.

(c) Encourage IT auditors to engage in other value-adding activities within the business without compromising their independence or the integrity of the audit.

(d) Ensure that audit plans are signed off at audit committee or chief audit executive level and that the head of audit reports to the board of the directors/audit committee.

(e) Integrate IT auditors and non-IT auditors to facilitate cross-learning of technical skills.

(f) Increase training in specialist skill areas such as IT security.

(g) Conduct end-of-engagement assessments to identify opportunities to improve skills and the efficiency of the audit process.

(h) Make better use of automated tools to handle volumes of data to enhance the reliability of audit conclusions.

(i) Make sure executive management reads the report and that comments are incorporated to enhance the perceptions and value of internal audit within the wider entity.

(j) Measure the quality of work undertaken by IT internal audit and implement satisfaction surveys. Communicate the results.

9 Computer forensics

Computer forensics (sometimes known as **computer forensic science**) is a branch of digital forensic science pertaining to legal evidence found in computers and digital storage media.

The goal of computer forensics is to **examine digital media** in a forensically sound manner with the aim of **identifying, preserving, recovering, analysing and presenting** facts and opinions about the information.

Although it is most often **associated with the investigation** of a wide variety of computer crime, **computer forensics** may also be used in civil proceedings. The discipline involves similar techniques and principles to data recovery, but with additional guidelines and practices designed to create a **legal audit trail**.

Evidence from **computer forensics investigations** is usually subjected to the same guidelines and practices of other **digital evidence**. It has been used in a number of **high profile cases** and is becoming widely accepted.

In court computer forensic evidence is subject to the usual requirements for digital evidence; requiring information to be authentic, reliably obtained and admissible.

The use of digital evidence has **increased in the past few decades** as courts have allowed the use of e-mails, digital photographs, ATM transaction logs, word processing documents, instant message histories, files saved from accounting programs, spreadsheets, Internet browser histories, databases, the contents of computer memory, computer backups, computer printouts, Global Positioning System tracks, logs from a hotel's electronic door locks, and digital video or audio files.

Forensic process

A number of techniques are used during **computer forensics investigations**:

Cross-drive analysis

A **forensic technique** that correlates information found on multiple hard drives. The process, which is still being researched, can be used for identifying social networks and for performing anomaly detection.

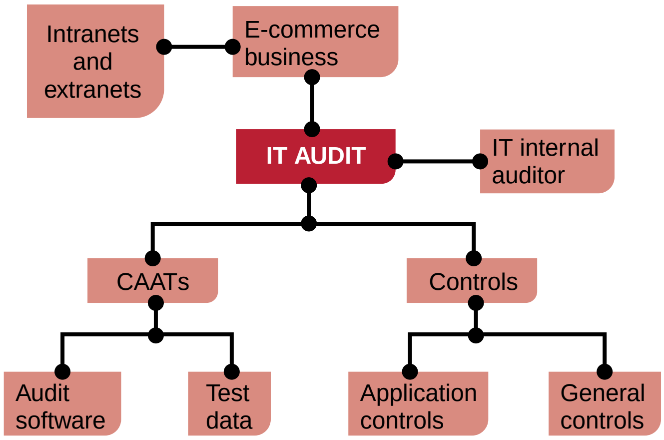
Live analysis

Live analysis involves the examination of computers from within the operating system using custom forensics or existing sysadmin tools to extract evidence. The practice is useful when dealing with Encrypting File Systems, for example, where the encryption keys may be collected and, in some instances, the logical hard drive volume may be imaged (known as a live acquisition) before the computer is shut down.

Deleted files

A common technique used in computer forensics is the **recovery of deleted files**. Modern forensic software have their own tools for recovering or carving out deleted data. Most operating systems and file systems do not always delete physical file data, allowing it to be reconstructed from the physical disk sectors. File carving involves searching for known file headers within the disk image and reconstructing deleted material.

Topic recap


Intranets and extranets
E-commerce business
IT AUDIT
IT internal auditor
CAATs
Controls
Audit software
Test data
Application controls
General controls

Answers to self-test questions

Answer 1

Securities trading is an example of an industry that has been transformed by e-commerce. Business risks a stockbroking company may face by introducing e-securities trading services to their customers include the following:

(a) Loss of transaction integrity, the effects of which may be compounded by the lack of an adequate audit trail in either paper or electronic form regarding the e-securities trading transactions.

(b) Pervasive e-commerce security risks, including virus attacks and the potential for the stock broking company to suffer fraud by customers, employees and others through unauthorised access to the e-securities trading system.

(c) Improper accounting policies (eg, capitalisation of expenditures such as website development costs for the e-securities trading system).

(d) Non-compliance with taxation and other legal and regulatory requirements, particularly when Internet e-securities trading transactions are conducted across international boundaries.

(e) Failure to ensure that contracts evidenced only by electronic means are binding.

(f) Over reliance on e-commerce when placing significant business systems or other business transactions on the Internet.

(g) Systems and infrastructure failures or “crashes”.

Internal controls can be used to mitigate many of the risks associated with e-commerce activities. The stockbroking company may implement an appropriate security infrastructure and related controls to address the business risks arising from e-securities trading services to their customers.

These include:

(a) Effective use of firewalls and virus protection software to protect the e-securities trading system from the introduction of unauthorised or harmful software, data or other material in electronic form.

(b) The effective use of encryption, including both maintaining the privacy and security of transmissions and preventing the misuse of encryption technology.

(c) Controls over the development and implementation of systems used to support the e-securities trading activities.

(d) Whether security controls in place remain effective as new technologies that can be used to attack Internet security become available.

(e) Whether the control environment supports the control procedures implemented.

Transaction integrity refers to the completeness, accuracy, timeliness and authorisation of information provided for recording and processing the entity’s financial records. Sophisticated e-commerce systems, such as the e-securities trading system, often involve establishing automated controls relating to the integrity of transactions as they are captured immediately and automatically processed. Examples of security measures used to ensure transaction integrity include encryption, hash totals, digital signatures, transaction certificates, bio-metrics and the use of eight-digit alpha-numeric passwords.

Process alignment refers to the way various IT systems are integrated with one another and thus operate, in effect, as one system. In the e-commerce securities trading environment, it is important that e-securities trading transactions generated from the stockbroker’s website are processed properly by the back office systems of the company. The stockbroking company should establish internal controls governing the integration of e-securities trading transactions with internal systems, and the controls over system changes and data conversion to automate process alignment.

In addition, the stockbroking company should maintain the integrity of control procedures in the rapidly changing e-commerce environment and ensure access to relevant records for its own needs and for audit purposes.

Answer 2

Consistent standard

- CEP deals with numerous distributors which are geographically spread out over Mainland China. Select statistically sampled inventory items to be test counted.
- An adequate standard of infrastructure, technical support and control procedures should be maintained in order to ensure all sites are suitable for the establishment of computer terminal devices.

Transaction trials

- It may not be practicable to verify the accuracy in the calculation of various rebates or payments to distributors after the transactions have been processed.
- Therefore, input data should be logged to provide some trails, eg through the issue of printouts at the terminal on a daily or weekly basis.

Security and backup

- Passwords for access to the system should be confidential subject to periodic prompted changes.
- Back-up files should be kept to avoid any disruptions and to ensure data integrity.

Answer 3

CAATs could be used to perform the following procedures:

- Compare the details of the inventory count book to the inventory master file to ensure completeness and accuracy.
- Select statistically sampled inventory items to be test counted.
- Select possible obsolete items by use of the last sale date and sales for the year.
- Select possible overstock or slow moving items by listing all items in excess of the economic order quantity.
- Verify mathematical accuracy by multiplying unit costs per the master file by quantities in the count book to equal the value of inventory.
- Verify the pricing by selecting key items and statistically selecting other items to be priced.
- Compare audit test counts to the final inventory list.
- List items with a count variance greater than specified limit.
- Summarise parts by date of sales to test aging analysis.
- Calculate write-down of inventory value for comparison with client calculation.
- Verify mathematical accuracy of total write-down.
- Compute inventory turnover ratios.
- Electronically archive audit documentation/ print audit documentation in an easy to read format.

Exam practice

Computer controls

25 minutes

QQQ Limited is engaged in the business of software development and has contracts with a portfolio of corporate clients to develop tailor-made computer software matching their users' needs and system requirements.

Required

(a) Most of QQQ Limited's clients are very concerned about the integrity of their software. Accordingly, they have insisted that QQQ Limited implements a series of effective internal controls over the software development process.

As the auditor of QQQ Limited, describe five internal controls that you expect to see in QQQ Limited at the designing and programming stages of software development.

(7 marks)

(b) As the Information Technology ("IT") assets owned by QQQ Limited are critical to its business success, describe five internal controls that you expect to see in QQQ Limited over the management of its IT assets.

(7 marks)

(Total = 14 marks)

HKICPA February 2010

Answers to exam practice questions

Chapter 1 Scope of corporate governance

T&F's corporate governance may be improved in the following ways:

Split the roles of Chairman and Chief Executive Officer (CEO)

Mr Lee's current roles as chairman and CEO of T&F should be separated between different individuals.

The CEO should manage the company, while the Chairman should run the board.

Lack of audit committee

T&F should form an audit committee with specific written terms of reference which reports back to the board on their decisions or recommendations relating to audit, accountability and financial reporting matters.

Appointing a separate audit committee helps T&F's board to concentrate on strategic and operational matters, leaving the audit committee to undertake the detailed financial reporting, internal control and financial review matters.

An internal audit department may be formed to report to the audit committee.

Balanced composition of the board

Directors on T&F's board do not have any financial expertise. T&F's board should include a balanced composition of executives and non-executives drawing from a range of relevant expertise.

In any kind of business, financial expertise is important. T&F should invite someone with financial expertise to join its board.

Chapter 2 Corporate governance reports and practice

(a) An effective audit committee can enhance the effectiveness, accountability, transparency and objectivity of the Manager's Board of Directors, and can also improve DREIT's corporate governance in the following ways:

External auditing

- Strengthen the position of DREIT's external auditor by providing an open channel of communication.
- Formulate a framework for DREIT's external auditor to maintain its independence when there are disputes with DREIT's management.

Financial reporting

- Improve the quality of financial reporting by reviewing the financial statements on behalf of DREIT's Board of Directors.
- Increase the involvement of the non-executive directors by assigning them to the audit committee to contribute independent viewpoints.
- Increase public confidence by raising the credibility and objectivity of DREIT's financial statements.

Internal control

- Strengthen the position of DREIT's internal auditor by separating it from executive management.
- Foster a culture of self-discipline, risk alertness and anti-fraud controls.
- Create a forum for DREIT's internal auditor in which the auditor can raise issues of concern, and which they can use to get things done which might otherwise be difficult.

(b) The effectiveness of DREIT's audit committee may be gauged in the following ways:

The Manager's Board of Directors is equivalent to DREIT's governing body which should have a balanced composition of executives and non-executives (to maintain objectivity) drawing from a range of relevant expertise. As a subset of the board, the audit committee should consist entirely of non-executive directors (at least three) particularly in the fields of accounting and finance. Also, some directors should have no financial interest in DREIT in order to maintain their independence.

Adequate resources should be set aside for the audit committee, so that an adequate number of members with the right calibre are appointed for access to management, external auditors and internal auditors.

DREIT's audit committee with proper terms of reference derives its authority from DREIT's Board of Directors under the requirements of the Listing Rules. Without proper authority, an audit committee would not be able to exercise the appropriate influence.

DREIT's audit committee should be diligent. This refers to the extent of willingness that DREIT's audit committee members have to work together to fulfill the requirements, including background study of agenda items, preparation of questions, checking progress, understanding problems and dealing with DREIT's management, internal auditors, external auditors and other stakeholders.

Chapter 3 Internal assurance

(a) HKSA 610 (Revised 2013) requires that auditors should perform an assessment of the internal audit function if they consider that it may be possible and desirable to rely on certain internal auditing work in specific audit areas for the purpose of the audit of financial statements.

When we obtain an understanding and perform a preliminary assessment of the internal audit function at Stone, we should consider the following:

The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors

We would consider the specific status of the internal auditing department at Stone and the effect of this specific status on the department's ability to be objective.

In the ideal situation, the internal auditors should report to the highest level of management and be free of any other conflicting responsibility.

We would carefully consider any constraints or restrictions placed on internal auditing by management.

In particular, the internal auditors should be free to communicate fully with us.

Scope of the internal audit function

We would consider the nature and extent of the assignments performed by the internal audit department.

We would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

Technical competence of the internal audit function

We need to consider whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors.

We would review the policies adopted by the internal audit department for hiring and training the internal auditing staff and the experience and professional qualifications of the internal auditors.

Whether the internal audit function applies a systematic and disciplined approach, including quality control

We would consider whether the internal auditing function is properly planned, supervised, reviewed and documented.

We would consider the existence of adequate audit manuals, work programmes and working papers.

(b) *Inventory count*

HKSA 501 (Clarified) requires that when inventory is material to the financial statements, the auditors should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory count by themselves or another auditor or a suitably qualified person representing them, unless impracticable.

Since Stone's inventories at 31 December 20X3 were approximately 25 % of the company's total assets, we are obliged to attend the physical count in accordance with HKSA 501 (Clarified).

In exceptional circumstances the auditors may judge it necessary to depart from this procedure in order to more effectively achieve the same objective, however the auditors should document the justification for this departure in the audit working papers.

We do not consider that the availability of internal auditors at Stone's is a valid justification for departure from this procedure, even though these internal auditors are considered to be competent and sufficiently independent.

Having an internal audit function is expected of a company with sound internal controls and does not constitute an exceptional circumstance in this case.

Confirmation

Since Stone's receivables balances at 31 December 20X3 were approximately 30 % of the company's total assets, it is important for us to obtain reliable evidence regarding the existence of the debtors at 31 December 20X3 through external confirmation.

HKSA 505 (Clarified) requires that when performing external confirmation procedures, the auditors should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of external confirmation requests, and the responses to those requests.

The purpose of our having control over the external confirmation process is to ensure the evidence obtained from the process is sufficiently reliable for our audit purposes.

In general, audit evidence obtained directly by us is more reliable than that obtained from Stone and audit evidence from external sources is more reliable than that generated internally by Stone.

We do not consider that confirmation obtained indirectly through the internal auditors of Stone is sufficiently reliable for our audit purposes.

Non-response is a failure of the confirming party to respond or fully respond to a positive confirmation request. Auditors shall perform alternative audit procedures to obtain relevant and reliable audit evidence.

An oral response does not meet the definition of an external confirmation because it is not a direct written response to the auditor.

Chapter 4 Code of Ethics

(a) Y&Z is the auditor of DEL.

Carol is the manager at Y&Z in charge of the audit of DEL.

Carol is the Company Secretary (i.e. an officer) of DEL.

Carol is responsible for making decisions of corporate secretarial matters at DEL.

Under the Code of Ethics for Professional Accountants - revised in June 2010 ("the Code"), Carol shall comply with the five fundamental principles. When Carol identifies threats to compliance with the fundamental principles and, based on an evaluation of those threats, determines that they are not at an acceptable level, Carol shall determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level.

By accepting DEL's employment offer and without any prior consultation with Y&Z, Carol appears to have violated the fundamental principles of integrity and professional competence and due care.

The position of company secretary has different implications in different jurisdictions, and duties may range from administrative duties and personnel management to providing advice on regulatory and corporate governance matters. Generally, this position is seen to imply a close association with the entity, even though Carol's position is only part-time.

Under the Code, performing routine administrative services to support a company secretarial function or providing advice in relation to company secretarial administration matters does not generally create threats to independence, as long as client management makes all the relevant decisions. However, it is not the case under Carol's circumstances.

(b) As Carol is an officer of DEL, the self-review, self-interest and advocacy threats created would be so significant that no safeguards could reduce the threats to an acceptable level.

Yvonne may consider to:

- Arrange for Y&Z to immediately resign from the audit of DEL; and/or
- Immediately terminate Carol's employment with Y&Z **and** change the audit plan for the forthcoming year as Carol might have knowledge about the audit arrangement.

Chapter 5 Framework for assurance engagements

2 Beauchamp Avenue
Broadway
SE 5

3 December 20X5

Noble Co
413 Gilroy Road
Causeway Bay

Dear Leonard,

Thank you for your letter. I hope the following comments resolve your queries.

(a) **Primary objectives of an audit**

The primary objective of the audit of a limited liability company is to **report to the shareholders** (the owners of the company) whereby the auditor expresses his opinion as to whether the accounts give a true and fair view (fairly presented) of the situation as reflected in the statement of financial position and the statement of profit or loss. In addition, the auditor will confirm whether in his opinion the accounts have been properly prepared with regard to applicable legislation.

(b) **Benefits**

The main benefits are as follows:

It gives the financial statements **credibility** and therefore gives the shareholders and third parties such as lenders confidence that the financial statements reflect fairly the position and the results of the company.

It can result in **improvements** to the accounting system and **internal control**. In the course of the audit the auditor will often identify areas of weakness in the accounting system and internal control. These are normally reported to management in the form of a management letter at the end of the audit.

The auditor can make recommendations regarding **business issues**. This could include matters relating to cost saving and operational efficiency.

The audit **may prevent and detect fraud**. This is not the primary purpose of the audit or the auditor's responsibility but the fact that an audit is to take place may discourage fraud in the first place. If it has occurred it may be detected by the auditor in the course of the audit work.

Chapter 6 Quality control

(a) In accordance with HKSA 220 (Clarified), the engagement partner should consider whether members of the engagement team have complied with ethical requirements.

The engagement partner should also form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:

- obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement;
- take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards;
- promptly report any failure to resolve the matter to the firm for appropriate action; and document conclusions on independence and any relevant discussions with the firm that support these conclusions.

(b) In accordance with HKSQC 1 (Clarified), the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, which are the Hong Kong Institute of CPA's Statements of Professional Ethics/Code of Ethics for Professional Accountants ("the *Code*").

The *Code* discusses the familiarity threat to an auditor's independence. A familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.

The *Code* considers the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat.

Accordingly, the firm should establish policies and procedures:

- 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
- 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*. The *Code* requires the rotation of the lead engagement partner for a listed client after a pre-defined period, normally no more than seven years.

In the case of ABC, the engagement partner and the engagement manager have been serving ABC since its listing on the Hong Kong Stock Exchange six years ago. It is not likely that, under the guidelines of the *Code*, a familiarity threat exists.

The firm must also consider the need to rotate the engagement partner in next year's audit.

Chapter 7 Changes in auditor appointment

(a) Gold and Silver should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements in accordance with HKSQC 1 (Clarified).

Gold and Silver should also ensure that appropriate procedures regarding the acceptance of the new client relationships are being followed and that conclusions are appropriate and documented, in accordance with HKSA 220 (Clarified).

Under the circumstances of the question, Ms. Or (and/or Gold and Silver) should consider the following matters:

- The integrity of Ms. Au;
- The integrity of other principal shareholders, key management and those charged with governance (and the extent of influences by Ms. Au on them);
- Whether the engagement team is competent to perform the audit engagement of a business in decorative lightings industry;
- Whether the engagement team has the necessary time and resources (in particular, Gold and Silver is short of manpower); and
- Whether Gold and Silver and the engagement team can comply with ethical requirements.

The engagement team should obtain such information as it considers necessary in the circumstances before accepting an engagement by ZZZ as a new client. Where issues have been identified and Gold and Silver has decided to accept the client relationship with ZZZ (in particular, the audit of its financial statements for the year ended 31 December 20X8), Gold and Silver should document how the issues are resolved.

(b) Ms. Or should consider the business reputation of Ms. Au, the key management, related parties and those charged with ZZZ's governance. The question has no information indicating that Ms. Au or the management of ZZZ is ignorant of the principles of corporate governance or the duties of directors.

Ms. Or should consider the nature of ZZZ's operations, eg whether or not ZZZ has been engaged in speculative activities and/or accepting unusually high business risks. Accepting unusually high business risks may suggest that the management is not acting in the best interest of ZZZ.

Ms. Or should consider whether or not ZZZ has been engaging in complex transactions or aggressive deals that make the determination of the effects on the financial statements unnecessarily highly subjective. Unless it is a business norm, unnecessarily complex transactions or aggressive deals may suggest that the management is not acting in the best interest of ZZZ.

Ms. Or should assess Ms. Au's attitude towards matters such as aggressive interpretation of accounting standards and/or the internal control environment, such as whether or not Ms. Au has exercised her power to override internal controls unnecessarily.

Ms. Or should find out whether or not the reasons for the non-appointment of Red and Blue related to the integrity of ZZZ.

Ms. Or should check whether or not Ms. Au displays a positive attitude towards compliance with regulatory or contractual obligations.

Ms. Or should check for any indication of money laundering and/or other criminal activities by Ms. Au (or ZZZ).

(c) Under the Code of Ethics for Professional Accountants (the *Code*) Section 440 "Changes in a Professional Appointment", Gold and Silver should find out whether the change of auditor has been properly dealt with in accordance with the Companies Ordinance or other legislation/regulations.

If the change of auditor has not been properly dealt with, Gold and Silver should not accept the invitation.

Gold and Silver should also request ZZZ's permission to communicate with Red and Blue.

Gold and Silver should not accept the invitation without first communicating in writing with Red and Blue to inquire whether there is any reason for or circumstance behind the proposed change of which they should be aware when deciding whether or not to accept nomination.

Section 440 of the *Code* requires Gold and Silver, with ZZZ's permission, to write to Red and Blue asking if there are any unusual circumstances surrounding the proposed change which Gold and Silver should be aware of, so that Gold and Silver may determine whether or not to accept the nomination.

Since ZZZ is a listed company, the change in auditor is also governed by Section 441 of the Code "Change of Auditors of a Listed Issuer of The Stock Exchange of Hong Kong".

In accordance with section 441 of the Code, Gold and Silver should request a copy of the letter of resignation and any correspondence referred to in the letter directly from ZZZ for consideration, in addition to the professional clearance from Red and Blue, before accepting the appointment.

If ZZZ refuses to provide Gold and Silver with a copy of the letter of resignation and any correspondence referred in the letter of resignation, Gold and Silver should decline the appointment.

Chapter 8 Planning, materiality and risk assessment

The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Risks of material misstatement at the financial statement level often relate to the entity's control environment.

The control environment of ABC includes: (1) its governance and management functions; and (2) the attitudes, awareness, and actions of ABC directors (e.g. Paul Cheung), and the management (e.g., Mr. Wong and his wife Helen) concerning ABC's internal control and its importance.

The nature of the risks arising from a weak control environment is such that the risks are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures.

In this case, Mr. Wong, the Personnel and Administrative Manager, took over the work of the supervisor of the accounts department. This indicated that Mr. Wong lacked awareness of the importance of the principle of segregation of duties in a sound control environment.

Mr. Paul Cheung's attitudes towards a sound internal control seemed to be affected by his close relationship with Mr. Wong and Helen, putting three important functions, namely, the accounting function, the warehouse function, and the personnel function, under the control of Mr. Wong and his wife, Helen.

Such a concentration of management power poses a higher risk of error. Errors may not be identified due to lack of checking by independent parties.

Risk of fraud would also be higher since any fraudulent action could easily be concealed.

In addition to a weak control environment, other conditions may also lead to higher risks of misstatement at the financial statement level. Such conditions may include aggressive business strategies, significant business risks arising from changes or complexity of business operations, and unusually high pressures on performance measures and review.

In this case, the company has entered a new market, i.e., the Mainland, and has adopted a new mode of business practice, ie, consignment sales.

ABC may not be so familiar with the new business environment and may therefore be exposed to higher business risks.

In addition, there was a high staff turnover in ABC's accounts department. If any replacement, eg, Mr. Wong, is not competent enough in financial reporting and internal controls, the risk of material misstatement at the financial statement level would be higher.

On the basis of the factors discussed above, risk of material misstatement at the financial statement level for the financial statements of ABC for the year ended 31 December 20X5 is assessed as medium (or high).

Chapter 9 Audit evidence, procedures, audit methodologies and audit sampling

(a) HKSA 530 (Clarified) *Audit Sampling* states that audit sampling involves the application of audit procedures to less than 100 per cent of items within a class of transactions or an account balance such that all sampling units have a chance of selection.

Sampling risk arises from the possibility that A & B's conclusion, based on a sample, may be different from the conclusion reached if the entire population were subject as to the same audit procedures.

Non-sampling risk arises from factors that cause A & B to reach an erroneous conclusion for any reason not related to the size of the sample, eg A & B might use inappropriate audit procedures, or A & B might misinterpret audit evidence and fail to recognise an error.

For both tests of controls and substantive test of details, sampling risk can be reduced by increasing sample size, while non-sampling risk can be reduced by proper engagement planning supervision and review.

(b) In performing substantive audit procedures (tests of details), a class of transaction or account balance may be stratified by monetary value. Therefore, A & B may stratify the outlets by the balances of cash floats (eg <$10,000 and $10,000+) and perform the substantive audit procedures on larger value items which may contain the greatest potential monetary error in terms of overstatement. However, it is important to make sure that the remaining part of the population (which is not tested) is not material. If it is material, samples from the remaining population should also be tested.

When there is a wide range (variability) in the monetary size of items in the population, it may be useful to group items of similar size into separate sub-populations or strata.

When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

In other words, the effectiveness of A & B's substantive audit procedures is higher when the sample (say five outlets) is chosen from the larger value items ($10,000+) compared to the sample (of five outlets also) being drawn from all 20 outlets.

Chapter 10 Fraud and irregularities

ABC Limited

(a) There are two types of fraud relevant to the auditor's consideration, ie fraudulent financial reporting and misappropriation of assets.

HKSA 240 (Clarified) states that the objective of the auditor is to identify and assess the risks of material misstatement of the financial statements due to fraud.

HKSA 240 (Clarified) also requires that the auditor must maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

HKSA 315 (Revised) requires that the auditor must obtain an understanding of the entity and its environment, including its internal controls, sufficient to identify and assess whether any of the risks identified are significant risks, including whether the risk is a risk of fraud.

(b) Fraud risk factors may be defined as any conditions or circumstances that may increase the risks of fraud.

As part of the risk assessment procedures required by HKSA 315 (Revised), the auditor must consider whether one or more fraud risk factors are present in order to identify the risks of material misstatement due to fraud.

The three conditions that are generally present when fraud exists are as follows:

- an incentive or pressure to commit fraud;
- a perceived opportunity to commit fraud; and
- an ability to rationalise the fraudulent action.

Risk factors reflective of an attitude that permits rationalisation of the fraudulent action may not be susceptible to observation by the auditor. Nevertheless, the auditor may become aware of the existence of such information.

(c) *Pressure from the US sub-prime mortgage crisis*

The financial stability of ABC is threatened by the US sub-prime mortgage crisis.
In particular, over 80% of ABC's sales are from customers in the US (financial institutions). Its business is therefore vulnerable to the downturn in the general economy and financial services sector in the US.

Pressure for a listing

There is a risk of excessive pressure on ABC's management to meet the requirements or expectations for a listing on the Hong Kong Stock Exchange in the near future in order to stay competitive.

Incentives to meet sales targets

There is a risk of excessive incentives for ABC's senior managerial staff to meet financial targets established under the new remuneration package, ie the more direct link to sales.

Opportunity for increasing related-party transactions

As an affiliated entity has recently been established in the US supporting ABC's main products, there is a risk of significant increase in related-party transactions with related entities not audited or audited by another firm.

Overly optimistic attitude of the CEO

Despite the slowdown in the US economy (and the US sub-prime mortgage crisis), Ms Chan's attitude to ABC's business appears to be overly optimistic, and Ms Chan does not appear to have discussed any strategies openly with Mr Kwok.

(d) As part of the risk assessment procedures required by HKSA 315 (Revised), Mr Kwok should consider any unusual or unexpected relationships that have been identified in performing analytical procedures.

Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications.

Mr Kwok may carry out analytical procedures on sales and trade receivables with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting, eg fictitious sales or concealment of irrecoverable trade debts.

The receivables turnover days are as follows:

For the year ended 30 June 20X9, receivables turnover days for US customers = 89.6 days

Receivables turnover days for other customers = 39.8 days

For the year ended 30 June 20X8,

Receivables turnover days for US customers = 73 days

Receivables turnover days for other customers = 36.5 days

In view of the above, the US customers (who comprise over 80% of ABC's sales) have taken much longer to pay compared to other customers. The time has been extended even further in 20X9 reaching 89.6 days. Against the background of the US sub-prime mortgage crisis, this indicates that ABC's US customers have experienced financial difficulties.

Sales from the US customers and the other customers have both increased by 10% from 20X8 to 20X9. Against the background of the US sub-prime mortgage crisis, it is odd to see an increase in sales to financial institutions in the US.

T&F Limited

(a) HKSA 240 (Clarified) *The Auditor's Responsibilities relating to Fraud in an Audit of Financial Statements* requires that an auditor conducting an audit in accordance with Hong Kong Standards on Auditing is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with Hong Kong Standards on Auditing.

The three prerequisites that are generally present when a fraud takes place are as follows:

- An incentive or pressure to commit fraud;
- A perceived opportunity to commit fraud; and
- Some rationalisation of the fraudulent act.

(b) The three fraud risk factors from the perspective of T&F's auditor are:

T&F's desire for a listing

T&F's desire for a listing within a year or two increases the pressures of inflating the sales and profits in order to meet the listing requirements.

Rapid growth and unusual profitability

T&F's sales have almost doubled from 20X9 to 20Y0 [482,100,000 / 254,300,000].

Despite the stable gross margin (ranging between 29% and 30%), T&F's net profits before tax have increased five times [98,100,000 / 16,200,000].

Such financial instability may represent misstatements arising from fraudulent financial reporting.

Questionable liquidity

T&F's current ratio has fallen from 1.2 to 0.9 despite the significant increase in profits.

The combination of rapidly rising profitability and questionable liquidity may represent misstatements arising from fraudulent financial reporting or misappropriation of assets.

Also, the difficulties in liquidity may increase the pressures to commit fraudulent financial reporting.

T&F's questionable liquidity may also explain the desire to go for a listing within a year or two.

Chapter 11 Internal control and tests of controls

Control activities are those policies and procedures which are established to achieve the entity's specific objectives and are designed to prevent, or to detect and correct errors.

HKSA 315 (Revised) requires that if the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities relevant to these significant risks.

HKSA 315 (Revised) states that the auditor shall obtain an understanding of control activities relevant to the audit.

Control activities that are relevant to the audit include:

- control activities that relate to significant risks or relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
- those that are considered to be relevant in the judgement of the auditor.

In addition, the auditor should consider whether management has specifically responded to these significant risks by:

- implementing control activities e.g. a review of the assumptions by senior management;
- documenting the processes and control activities; and
- review and approval by those charged with governance the control activities.

Chapter 12 Substantive procedures, including analytical procedures

(a) The most important financial statement assertions tested in:

Situation 1

Existence of inventories

Valuation and allocation of inventories – limited to the details that can be observed and confirmed

Situation 2

Existence of inventories
Valuation and allocation of inventories – limited to the details that can be observed

Situation 3

Completeness of trade payables
Rights and obligations of trade payables

Situation 4

Existence of bank balance
Valuation and allocation of bank balance
Rights and obligations of bank balance

(b) More persuasive sources of evidence in:

Situation 1

Source A, observation of the counting of the client's inventory, is more persuasive because:

(1) the auditor obtains the evidence directly (including the effectiveness and reliability of counting procedures by the client); and

(2) although the warehouse is independent, there may be questions about its competence and integrity. In addition, some warehouses do not have strong internal control and reporting systems for them to readily respond to such requests.

Situation 2

Source B, physical examination of the metal sheets, is more persuasive because:

(1) it is easier to count and identify;

(2) the grade/quality is usually marked on metal sheets; and

(3) there are generally no major obsolescence problems with metal sheets. However, the nature and quality of sophisticated electronic equipment are more difficult to ascertain.

Situation 3

Source B, request for suppliers' confirmations, is more persuasive if the auditor has sufficient information to contact all major suppliers and most suppliers respond to the auditor's request. Confirmations are an independent source of evidence.

Many auditors use the first approach (Source A) by examining payments subsequent to the year-end, which can still provide reasonable assurance if the client pays its bills on a regular and timely basis and has sufficient controls to ensure that all bills are identified for payment and if there is no particular risk of overstatement of trade payables.

Situation 4

Source A, confirmation of the year-end bank balance, is more persuasive because:

(1) the confirmation is an external source of evidence; and

(2) the confirmation can provide more comprehensive information than bank statements, such as liens on assets and contingent liabilities.

Chapter 13 Specific audit procedures

X Limited

The amount shown in X Limited's trade receivables should be the outstanding amount on trade receivables less impairment loss for irrecoverable debt.

Audit procedures on sales and trade receivables are usually combined due to the inter-relationship between the two items in accounting procedures and internal control systems.

X Limited's auditor should understand and evaluate the major activities that X Limited uses to monitor internal control over financial reporting which, in this case, include the design and operating effectiveness of the accounting procedures and internal controls relating to sales and trade receivables. These accounting procedures and internal controls should cover:

- billing procedures and recordings of sales and receivables;
- quality assurance / control procedures over products before and after delivery;
- credit policies and controls;
- collection of trade receivables; and
- procedures adopted by X Limited's management in the identification and estimate of impairment loss for irrecoverable debt.

X Limited's auditor should carry out some of the following substantive procedures:

- send a confirmation to C Limited and other debtors;
- compare the balance to the relevant turnover and previous months / years;
- compare the aged analysis to other debtors and previous months / years;
- discuss with management (and X Limited's lawyer) the nature and status of the dispute;
- discuss with management (and X Limited's lawyer) the recoverability of the entire balance HK$2,589,000;
- discuss with management the implications (if any) of C Limited's claims (product quality) on other debtors or accounts;
- check for any subsequent settlement from C Limited and other long outstanding debtors; and
- check for any returns of goods from C Limited and other customers.

Z Construction

(a) The bank reconciliation audit procedures should include:

- Reperform arithmetic of bank reconciliation.
- Trace cheques shown as outstanding from the bank reconciliation to the cash book before the year end and to the after-date bank statements and obtain explanations for any large or unusual items not cleared at the time of the audit.
- Review bank reconciliation before the financial year end and check that all items are cleared in the last month or taken forward to the year end bank reconciliation.
- Obtain satisfactory explanations for all items in the cash book for which there are no corresponding entries in the bank statement and vice versa by discussion with finance staff.
- Verify by inspecting pay-in slips that uncleared bankings are paid in before the financial year end.

- Verify balances per the cash book according to the bank reconciliation by inspecting cash book, bank statements and general ledger.
- Verify the bank balances with reply to standard bank letter and with the bank statements.

(b) In accordance with HKSA 505 (Clarified) *External Confirmations*, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity.

Bank guarantees or performance bonds

Under the circumstances of Z Construction (which is a construction company), the client / developer usually requires the construction company to buy a performance bond issued by a bank or insurance company. A performance bond generally refers to a bank's surety (or a financial institution's guarantee) bought by the construction company in the role as a project's contractor to guarantee the satisfactory completion of the project.

The bank confirmation reply from the bank should disclose any performance bonds issued for Z Construction.

It is possible that Z Construction's performance bonds are issued with recourse which would form a contingent liability.

Some of Z Construction's bank balances may be pledged with the bank in order to secure some credit lines (including bank guarantees and performance bonds). Benny and his team should check appropriate disclosure is made on the financial statements.

Bank loans

Z Construction is in a capital-intensive industry and often requires funding in addition to the shareholders' equity. Bank loans and other credit facilities are commonly seen on construction companies' financial statements.

Benny and his team should seek to confirm the amounts and terms (particularly the interest rates and repayment terms) of these loan and credit facilities.

(c) The construction industry involves the interaction of many different parties including clients, vendors, contractors and/or sub-contractors. There are a variety of contracts amongst these parties, and conflicts can easily arise leading to disputes and litigations.

Therefore, Benny and his team should seek direct communication with Z Construction's external legal counsel through a letter of general inquiry. For this purpose, the letter of general inquiry requests Z Construction's external legal counsel to inform Benny of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

In order to delegate the contractual requirements into manageable amounts of work amongst various sub-contractors, Z Construction is often engaged in many back-to-back contracts or arrangements based on the head contract.

Benny and his team should check if there are any claims, disputes or litigations from/to the client, sub-contractors and other relevant parties (e.g. injured employees).

Inventory

(a) The risk of material misstatement over the inventory valuation is high. The increase in risk of material misstatement over the inventory valuation is mainly due to:

- the inventory balance as at year end is significant to the company's total assets (i.e. 20%). Any material misstatement in the inventory balance could result in pervasive misstatement in the financial statements as a whole.

- the financial trend does not look reasonable. The increase in inventory is far more than the company's plan of expansion which indicates that there may be slow-moving inventory piling up.
- the deterioration of inventory ageing suggests that there may be slow-moving inventory and management should factor it in the inventory provision assessment.
- management's assessment of inventory provision purely relies on past trend without taking into account a totality of facts which may indicate management bias.

(b) In response to the risk of material misstatement over the inventory valuation, the following audit procedures should be considered:

- validate the managing director's representation by obtaining the company's expansion plan and an understanding in detail of how their expansion plan affects the inventory balance as at year end;
- obtain from management their inventory provision assessment and understand the judgment and assumptions used in the assessment;
- evaluate the reasonableness of management's judgment and assumptions used in the inventory provision assessment;
- test the data used in the inventory provision assessment;
- consider management's response and if there is an indicator of possible management bias;
- ask the management if they have an inventory realisation plan;
- check subsequent sales and compare them with the inventory realisation plan;
- understand and evaluate management's controls over the assessment of inventory provision.
- test the operating effectiveness of the management's controls over the assessment of inventory provision, in particular:
  - (i) validate whether controls exist for the review and approval of the inventory provision by appropriate levels of management and those charged with governance; and
  - (ii) validate whether the inventory provision is derived from the routine processing of data by the entity's accounting system (e.g. provision is determined by making reference to inventory ageing and with an appropriate inventory provision set-up applied across the group).
- develop a point of estimate or a range based on independent data for assessing the appropriateness of the inventory provision;
- perform detailed analysis on inventory ageing (by products, by brand lines) to identify if specific provision is required for certain brand products; and
- consider the totality of facts, both management's representation and the independent data acquired, make a final assessment as to whether the reasonableness of the accounting estimates on inventory provision determined by management would lead to material misstatements.

Cash and bank

(a) The risk of material misstatement on cash and bank balances is high because of the following:

- the bank reconciliation process does not operate effectively which may increase the risk of unidentified accounting errors and adjustments; and

- there is an increased opportunity for misappropriation of cash given that the management's processes and controls were not properly exercised by the operation team.

(b) The audit team should consider the following audit procedures in response to the risk of material misstatement over cash and bank balances identified in (a):

- review the Internal Audit Report in detail, discuss findings with management and reassess the risk of material misstatements of cash and bank balance;
- understand from management the remedial action plan and implementation timeline;
- identify whether there are compensating controls and consider performing the testing of the compensating controls by understanding, evaluating and validating the key management compensating controls;
- instead of relying on management's control over cash management, consider a substantive testing approach by performing test of details;
- circulate bank confirmations directly to every bank with which the company conducted business; verify the bank balances with the replies to the standard bank letter;
- check the bank balances against the respective bank statements;
- reperform the bank reconciliation by comparing the cash ledger balance and the balance stated on bank statements/bank confirmations, obtain an explanation from management for any large or unusual items not cleared at the time of audit;
- obtain satisfactory explanations for all items in the cash book for which there are no corresponding entries in the bank statement and vice versa through discussion with finance staff; and
- check subsequent bank statements to confirm the validity of the bank reconciliation items (e.g. un-presented cheques).

Chapter 14 Using the work of others

The management of the new client have used a management's expert to assist them with the valuation of properties in order to prepare the financial statements. Where information used as audit evidence has been prepared using the work of a management's expert, HKSA 500 (Clarified) requires the auditor to:

- evaluate the competence, capabilities and objectivity of that expert
- obtain an understanding of the work of the expert
- evaluate the appropriateness of that expert's work as audit evidence for the relevant assertions.

In this case specifically, to ensure that HVSL is a suitable candidate to rely on, the firm needs to consider the following:

- Are the surveyors involved in the valuation professionally qualified? (Are they qualified members of a professional surveying bodies, like the Hong Kong Institute of Surveyors?)
- Do the surveyors involved in the valuation have appropriate experience in the valuation of residential properties under development in Hong Kong?
- Does HVSL rely heavily on work (valuation as well as other works normally performed by a firm of surveyors) initiated by the company?
- Does HVSL or any of its management or staff have a financial interest in the company?
- Does HVSL or any of its management or staff have any close personal relationship with the directors of the company?

If the auditors conclude that they themselves do not have the relevant expertise to obtain sufficient, appropriate audit evidence regarding the valuations they may consider it necessary to use an auditor's expert in accordance with HKSA 620 (Clarified).

Chapter 15 Accounting estimates, opening balances and comparatives

(a) Under HKSA 510 (Clarified) *Initial Audit Engagements – Opening Balances*, the audit of Ling Limited's financial statements for the year ended 30 June 20X1 is an initial audit engagement for Cod CPA.

Ling Limited's balances of inventories and accounts receivable as at 1 July 20X0 represent the opening balances for Cod CPA in the audit of Ling Limited's financial statements for the year ended 30 June 20X1.

Therefore, Cod CPA's audit objective with respect to the opening balances of inventories and accounts receivable is to obtain sufficient appropriate audit evidence as to whether:

- Opening balances contain misstatements that materially affect Ling Limited's financial statements for the year ended 30 June 20X1;
- Appropriate accounting policies reflected in the opening balances have been consistently applied in the financial statements for the year ended 30 June 20X1; and
- (If changes are made to accounting policies) these changes are appropriately accounted for and adequately presented and disclosed in accordance with the Hong Kong Financial Reporting Standards and the Hong Kong Companies Ordinance.

(b) Haddock CPA qualified its audit report on two main aspects – a balance of certain inventories at HK$1,300,000 and a balance of certain accounts receivables at HK$1,147,000 – as at 30 June 20X0. These two balances represent the opening balances on Ling Limited's financial statements for the year ended 30 June 20X1 which are subject to Cod CPA's audit.

Cod CPA may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing Haddock CPA's working papers.

However, in view of Haddock CPA's qualified audit report, such a review is not likely to be sufficient.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.

In respect of the opening balance of inventories at HK$1,300,000, Cod CPA's audit procedures for the year ended 30 June 20X1 on the closing inventory balance provide little audit evidence regarding inventory on hand at 1 July 20X0.

Therefore, additional audit procedures may be necessary, such as:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profits and cut-offs of various inventory items.
- Obtaining a confirmation with any relevant third parties, e.g. a public warehouse.

In respect of the opening balance of accounts receivable at HK$1,147,000, the collection of the opening accounts receivable during the year ended 30 June 20X1 (in particular, during the first few months of the financial year) can provide some audit evidence of their existence, rights and obligations, completeness and valuation at 1 July 20X0.

Chapter 16 Overall audit review and finalisation

Hong Kong Toys Company Limited

(a) In accordance with HKSA 550 (Clarified), the engagement team should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by the management of related parties.

The engagement team should (1) review information provided by directors/management of HKT identifying the names of all known related parties; and (2) perform audit procedures in respect of the completeness of this information.

Given that all the five members of the Chan family are directors of HKT, they should all be included in the list of related parties of HKT, since they are either a member of the key management personnel of HKT, or a party having significant influence over HKT.

To test the completeness of the list of related parties, the engagement team may:

- review prior year working papers of HKT to identify any other parties known to be related to HKT;
- review HKT's procedures for the identification of related parties;
- inquire as to the affiliation of directors and officers with other entities, such as the names of close members of the family, controlling or significant interest in other entities etc;
- review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;
- review minutes of the meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests; and
- review HKT's income tax returns and other information supplied to regulatory agencies.

The engagement team should also determine whether the related party relationships are required to be disclosed in accordance with the applicable financial reporting framework, ie HKFRSs in this case.

Given that all the Chan family members are shareholders and directors of HKT, the engagement team should also determine whether their relationship with HKT should be disclosed in accordance with the Companies Ordinance as well.

(b) The principal related party transactions of HKT would be (i) the rental of office premises from one of its shareholders/directors at HK$500,000 per month, and (ii) the remuneration paid to the directors for services rendered to the company.

HKT should have provided the engagement team with details of these related party transactions.

The engagement team should review this information provided by the directors/management of HKT and should be alert for other material related party transactions.

The engagement team should also consider the adequacy of control activities over the authorisation and recording of related party transactions.

For example, the engagement team should consider whether the tenancy agreement and monthly payments are authorised by a director or director(s) other than the one owning the office premises.

The engagement team should obtain sufficient appropriate audit evidence as to whether these identified related party transactions have been properly recorded and disclosed in the financial statements.

For these purposes, the engagement team should confirm the terms and amount of the transaction with the related parties, for example, confirmation from the directors of the amounts of remuneration they received, and/or rental income the shareholder/director received, from HKT.

The engagement team may also inspect information in possession of the related party, such as the services contracts with the directors and the tenancy agreement with the shareholder/director.

During the course of the audit, the engagement team should be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties.

The engagement team should obtain a written representation from management of HKT concerning the completeness of information provided regarding the identification of related parties, and the adequacy of related party disclosures in the financial statements.

X Limited

Under HKSA 570 (Clarified) *Going Concern*, X Limited's auditor shall obtain sufficient appropriate audit evidence about the appropriateness of X Limited management's use of the going concern assumption in the preparation of the financial statements and conclude whether there is a material uncertainty about X Limited's ability to continue as a going concern.

Accordingly, the auditor shall consider the going concern uncertainty affecting X Limited which includes the following main issues.

Loss of the distribution rights for Brand A

As the distribution agreement with A Corp will expire on 31 March 20X1, X Limited may soon lose its distribution rights to sell its main brand of household electric appliances in Hong Kong.

Without Brand A products, the shops of X Limited may not be able to operate or survive.

Uncertainty about the sales and profits of new products (if any)

X Limited should search for new products to maintain the availability of a good product range in its shops after the loss of its distribution rights for Brand A. There is uncertainty in respect of X Limited's ability to secure new products.

Even if new products are put on the shelves, there is uncertainty whether those new products can sell and produce profits for X Limited.

Provision for the costs to be incurred under the warranty

The costs to be incurred under the two-year warranty are supposed to be covered by the provision.

However, the amount of provision is likely based on a management forecast, and there is uncertainty in respect of the reliability of such a forecast and its assumptions.

The degree of uncertainty will be particularly high when X Limited no longer sells Brand A products and is likely to lose any technical support currently received from A Corp.

Rental commitment

As X Limited has five retail shops in Hong Kong, there is uncertainty in respect of the remaining terms of X Limited's rental commitment on these retail shops.

If the rental commitment goes beyond 31 March 20X1, the flexibility of X Limited to adopt a new business model and to sell new products (or even its survival) would be threatened.

Chapter 17 Audit reporting

(a) The types of auditors' opinions that may be expressed in the auditors' report may be:

(i) Unmodified; or
(ii) Modified:

(1) Inability to obtain sufficient appropriate audit evidence
(2) Financial statements are materially misstated.

The financial statements can reflect only the working assumptions of directors as to the financial outcome of inherent uncertainties (ie the value of the washing machines and dryers to the business is greater than $500,000 when the shop is profitable) and, where material, describe the circumstances giving rise to the uncertainties and their potential financial effect.

The auditors of QQ are required to consider the view given by the financial statements and the adequacy of any disclosures. Where the auditors are in agreement with the valuation given to the non-current assets and are satisfied that the level of any necessary disclosures is adequate an unmodified audit opinion would be issued. However if the auditors conclude that it is necessary to draw the users' attention to this matter and in the auditors' judgment it is of such importance that it is fundamental to the users' understanding of the financial statements the auditors are required by HKSA 706 (Clarified) to include an Emphasis of Matter paragraph. This should make clear the issue surrounding the value of the non-current assets and refer to the disclosures made in the financial statements. It should also clearly indicate that the audit opinion is not modified in this respect.

In determining whether the issue is fundamental, the auditors of QQ should consider:

- the risk that the estimate included in the financial statements may be subject to change;
- the range of possible outcomes; and
- the consequences of those outcomes on the view shown in the financial statements.

The auditors must also consider whether there is any doubt regarding the use of the going concern assumption. In accordance with HKSA 570 (Clarified) where there is a material uncertainty about the use of the going concern assumption an Emphasis of Matter paragraph should be included in the audit report.

(Candidates are free to express a different view with adequate reasons and explanations, eg HKSA 510 (Clarified).)

(b) In accordance with HKSA 705 (Clarified), since the auditors disagree with the management's assessment of the valuation of the non-current assets at the loss-making shop, and the effect of that disagreement is that the financial statements are materially misstated, the auditors must modify the audit opinion. The auditors must include in the opinion section of their report:

- A description of all substantive factors giving rise to the disagreement;
- The implications of these factors for the financial statements; and
- Whenever practicable, a quantification of the effect on the financial statements.

Where the misstatement is material but not pervasive the auditor should issue a qualified (except for disagreement) opinion indicating that it is expressed except for the effects of the matter giving rise to the misstatement (ie the washing machines and dryers are worth nothing if the loss-making shop is closed).

If the auditors conclude that the effect of the matter giving rise to disagreement is so material or pervasive that the financial statements are seriously misleading, the auditors should issue an adverse opinion.

(Candidates are free to express a different view with adequate reasons and explanations.)

Chapter 18 Group audits

(a) HKSA 600 (Clarified) requires the group auditor to determine the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor.

In view of the significance of the retail business in Asia Pacific (i.e. contributing 20% of revenue and 10% of net profit to the group), the group auditor should classify the retail business in Asia Pacific as a significant component as it is individually financially significant.

The group auditor should request the component auditor to perform an audit of the financial information of this significant component using component materiality. In addition, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider the following audit procedures:

- meet with the retail business' management or the component auditor to obtain an understanding of the retail business and its environment;
- review the component auditor's overall audit strategy and audit plan;
- perform risk assessment procedures to identify and assess risk of material misstatement of the retail business. This may be performed together with the component auditor or by the group engagement team;
- discuss with the component auditor or the retail business' management regarding the components' business activities that are significant due to fraud or error, by considering fraud risk factors;
- review the component auditor's documentation of identified significant risks of material misstatements;
- consider significant findings of the component auditor; and
- discuss with the component auditor or the retail business' management if there is disagreement on the accounting treatment or other matters among the group auditor, the component auditor and the retail business' management.

(b) Given the component is now audited by a local auditor about whose competence, independence and objectivity you do not have much information, the group auditor's involvement in the work of the component auditor should be considerably increased in terms of nature, timing and extent.

The group auditor should consider the following audit procedures:

- assess the competency, independence and objectivity of the component auditor, in particular:
  - competency: whether the local auditor has sufficient expertise and experience in the real estate industry audit;
  - objectivity: whether the local auditor is biased or has conflicts of interest or undue influence to override professional and business judgement; and
  - independence: whether the local auditor is independent from Solid Inc. and its related companies;
- seek confirmation from the local auditor regarding their competence, independence and objectivity;
- visit the component auditor to discuss its competence, independence and objectivity;
- request the component auditor to complete questionnaires about its competence, independence and objectivity;

- discuss the component auditor with colleagues in the group auditor's firm, or with a reputable third party that has knowledge of the component auditor;
- obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties;
- if the group auditor considers that there is an issue regarding the local auditor's competence, independence and objectivity, the group auditor cannot overcome the fact that the local auditor is not independent by being involved in the work of the local auditor or by performing additional risk assessment or further audit procedures on the financial information of the component, the group auditor should consider performing the following further audit procedures, such as:
  - perform the audit work themselves instead of relying on the local auditor's findings;
  - supervise the component auditor directly and review their work papers; and
  - review in detail the local auditor's audit findings and evaluate the appropriateness of their audit conclusion
- however, the group auditor may be able to overcome less than serious concerns about the local auditor's competency by being involved in the work of local auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

(c) The partner in charge of the shipping business audit has extensive knowledge and experience of the client. He has been involved in the shipping business audit for seven years and is close to the senior management.

The group auditor should consider whether the partner in charge is subject to a familiarity threat and self-interest threat.

The group auditor should evaluate the significance of the threats and consider other safeguards as suggested in the Code of Ethics for Professional Accountants (Revised).

For example:

- rotating the partner in charge of the audit team;
- having another professional accountant in the firm who is not a member of the audit team review the work of the partner in charge; and
- having regular independent internal or external quality reviews of the engagement.

Chapter 19 Audit-related services and other assurance engagements

(a) The first problem is that this is a high risk audit. The entity is small and under the direct control of three shareholder/directors. It is highly unlikely that there will be significant control systems beyond the direct observation and supervision imposed by the directors. This may well impair the evidence that is available from substantive tests as well as internal control. Small entities can have effective control systems, but they are likely to be implemented differently from those in larger businesses.

This is also a high risk audit in terms of global inherent risks. The company is expanding and wishes to raise a loan. That could put the directors under pressure to distort the results of the statement of financial position and cash flows of the company. The auditor will have to take particular care in testing the non-current assets and the elements of working capital. The directors are under a certain amount of pressure to manipulate those areas.

This is a new audit. There is no prior knowledge or experience of the business. The auditor has not had an opportunity to assess the competence or the integrity of management. It will be difficult to determine whether the figures in the draft financial statements appear valid or sensible because past statements will not have been audited.

The circumstances described in the two preceding paragraphs also raise concerns about the extent to which the auditor can rely on representations from management.

The terms of this engagement make it rather more sensitive than normal. The bank is clearly going to look to the auditor for a duty of care. The auditor will have to determine the basis on which the statements are to be prepared and reported on. Is this normal accounting convention or some specialised approach to reporting that is favoured by the bank (eg more conservative than usual)? The extent to which the auditor is reporting to the bank as opposed to the shareholders should be determined and agreed upon in writing. The auditor should also determine whether the bank wishes any specific tests to be conducted.

The auditor will have to document any and all matters that involve professional judgment with particular care. This audit report could well be the subject of some dispute at a later date and the audit working papers will be the only way to defend any allegations of negligence.

(b) The auditor is almost certainly liable to the bank. The report described by the directors is apparently to be addressed to the bank.

The auditor can mitigate this responsibility by taking care in the wording of the report. The independent accountant's report could indicate the extent to which the figures have been checked and tested. If the evidence gathered leaves scope for uncertainty as to the accuracy of the results then that can be made clear. It should also be made clear that the bank should take care to establish the basis on which the figures have been prepared and presented. That could have implications for whether they form a suitable basis for the lending decision. If the auditor feels that further investigations should be made by the bank then that should be made clear.

Chapter 20 Information technology

(a) In the designing and programming of software, QQQ Limited may have the following internal controls in place:

- Draw up the designs that demonstrate fitness for purpose, reliability, efficiency, security, safety, maintainability and cost effectiveness.
- Follow the designs and produce well-structured codes of programming that facilitate testing and maintenance.
- Balance the designs with requirements for functionality, service quality and systems management and later stages in the development life cycle (such as testing).
- Maximise opportunity for re-usability, consider the general applications of the designs, and check any existing designs that could be re-used.
- Ensure that the designs can be used by both experienced and inexperienced users (otherwise appropriate training should be arranged).
- Establish a self-explanatory system in coding and file labelling in order for other programmers to follow.
- Identify any pitfalls on the platform (operating system and hardware) and minimise any inefficiency in programming.
- Reserve rooms for future upgrades.

(b) In managing IT assets, QQQ Limited ("QQQ") may have the following internal controls in place:

- Implement a firm wide policy setting out QQQ's commitment to safeguard its IT assets and promote awareness of this policy within QQQ and to the customers and suppliers.
- Segregate the duties of managing QQQ's IT assets as far as possible in respect of purchase, receipt, installation, transfer and disposal.
- Have both software and physical controls in place to safeguard QQQ's IT assets from thefts or misappropriations.
- Prohibit the uploading or downloading of unlicensed software onto QQQ's IT assets.
- Have all uploading or downloading of software properly authorised by owners or licensors.
- Raise the awareness of relevant legislations, such as data protection and data privacy.
- Carry out surprise audits on QQQ's IT assets on a periodic basis.
- Ensure compliance with all licensing terms, including the numbers of users and computers running the software.

Question bank – questions

CASE STUDY 1

Cheese and Cream Cake Limited ("CCC") is a limited liability company incorporated in Hong Kong. CCC is a chain of upmarket cake shops with five shops in Central, Admiralty, Causeway Bay, Tsim Sha Tsui and Tai Kok Tsui respectively. The shops in Admiralty and Tai Kok Tsui are located within upmarket shopping malls, whilst the rest are on main street at prime locations.

Mr. Tom Tam ("the Father") and his wife ("the Mother") founded CCC about fifteen years ago and introduced some special ingredients into tiramisus and American cheese cakes which have become very popular amongst local customers. The Father had 80% of CCC's equity, whilst the Mother held the remaining equity. The couple's two daughters (known as "the 1st Daughter" and "the 2nd Daughter" respectively) helped the Father to operate CCC until 20X5.

The Father passed away in 20X5, and the 1st Daughter and the 2nd Daughter have each inherited 40% of CCC's equity from him. The 1st Daughter and the 2nd Daughter have jointly managed CCC since then.

CCC is regularly featured in the media and has received various best quality and favourite cakes awards. Local customers as well as tourists from mainland China and overseas are attracted by its speciality tiramisus and American cheesecakes.

ABC & Co has been the auditor of CCC since 20X3. Mr. Au at ABC & Co. ("ABC") is the engagement partner in charge of CCC's audit. Between 20X3 and 20X6, ABC's audit opinions on CCC's financial statements were all unqualified. CCC's management accounts for the year ended 31 December 20X7 show a net profit of HK$19 million.

In 20X6, CCC started packaging its specialty tiramisus and American cheesecakes in sealed boxes for sale in department stores in order to take advantage of the booming tourism and retail market in Hong Kong. Gift vouchers were also introduced in 20X6 and have proven to be a very successful initiative when many customers bought the gift vouchers as Christmas presents for their families and friends.

There have been heated arguments between the 1st Daughter and the 2nd Daughter over the direction and operation of CCC's business since the Mother passed away in early 20X7. The Mother left her entire stake in CCC's equity to the 1st Daughter who has become the majority shareholder. The 1st Daughter has put her son on the Board of CCC. The 2nd Daughter has accused the 1st Daughter of abusing her powers in the running of CCC's business.

In mid-20X7, a discrepancy in the stock of gift vouchers with a total face value of HK$1.1 million was discovered. The stock of gift vouchers in hand could not be reconciled with the quantity issued and sold to customers. Comparing the print-runs and stacks of gift vouchers with the stock held in hand indicated that gift vouchers with a face value of HK$2.5 million were issued between January 20X7 and June 20X7. However, the sales records only showed that gift vouchers totalling HK$1.4 million were sold during the same period.

In mid-20X7, CCC's management requested a proposal from a computer consulting firm in respect of the design, supply and installation of an integrated computer system. Under the proposed system, CCC seeks to link together its accounting and operating functions and to feed the sales and inventories records of the five shops into the headquarters accounting system giving real-time information for the management to make timely decisions, such as changing the product-mix and facilitating the procurement arrangements.

In late-20X7, the 2nd Daughter, through her lawyers, warned that she would apply for the winding-up of CCC and argued that she could no longer tolerate the 1st Daughter's abuses of power. CCC's prosperous business appears unaffected by the dispute between the 1st Daughter and the 2nd Daughter.

The 1st Daughter has offered to buy the 2nd Daughter's shares as CCC's business is a going concern and it would not make any sense to wind it up. Before the winding-up petition is filed, the 1st Daughter and the 2nd Daughter have resolved their row in a mediation and have agreed to jointly appoint a single expert in assessing a fair value of CCC's equity which could possibly form the basis for the 1st Daughter to buy the 2nd Daughter's equity.

In December 20X7, the 1st Daughter expressed her intention to appoint ABC as the single expert. However, the 2nd Daughter nominated another CPA firm to carry out the valuation.

In January 20X8, a group of tourists from mainland China was reported to have suffered from severe food poisoning after eating CCC's tiramisus and were hospitalised for a few days. A formal complaint was filed with CCC's management in February 20X8, and a lawsuit is likely to follow if CCC fails to come up with a proposal acceptable to the victims.

Question 1 — 22 minutes

ABC & Co. ("ABC") is currently considering whether or not to act as the single expert in the valuation.

Required

(a) What independence issues should ABC address? **(8 marks)**

(b) What possible safeguards should ABC put in place? **(4 marks)**

Question 2 — 22 minutes

Identify and explain the specific controls that should be in place to ensure the proper functioning of CCC's proposed integrated computer system.

(12 marks)

Question 3 — 31 minutes

ABC is currently planning for the audit of CCC's financial statements for the year ended 31 December 20X7.

Required

(a) Other than fraud risks, identify and explain the risk of material misstatements at the assertion level for particular account balance(s) in response to the discrepancy in gift vouchers.

(5 marks)

(b) Identify the internal controls which should be in place relating to the issue, redemption, safekeeping and recording of gift vouchers.

(4 marks)

(c) Discuss how ABC should exercise professional scepticism in response to the discrepancy in gift vouchers.

(8 marks)

Question 4 — 15 minutes

ABC has substantially completed the audit of CCC's financial statements for the year ended 31 December 20X7. The discrepancy in gift vouchers has been resolved, and ABC is generally satisfied that there are no material misstatements. ABC has just been notified by CCC's management about the food poisoning scandal.

Required

Discuss the audit procedures that ABC should carry out in respect of the food poisoning scandal before concluding its audit opinion on CCC's financial statements for the year ended 31 December 20X7. Comment on the disclosure requirement.

(9 marks)

(Total = 50 marks)

HKICPA December 2012 (amended)

CASE STUDY 2

Super Energy Limited ("Super Energy") is a global oil company listed in Hong Kong. It has operations in over 50 countries and is one of the largest energy companies in the world. It produces around the equivalent of 2 million barrels of oil per day and has over 10,000 petrol service stations worldwide.

Super Energy's headquarters are in Hong Kong. It is vertically integrated from exploration and production, refining, distribution and marketing to petrol station retailing. Its largest oil production plant is in America.

Super Energy's track record of corporate social responsibility has been mixed. The company has been involved in a number of major environmental and safety incidents and received criticism for its political influence. However, it is also the first major oil company to publicly acknowledge the need to take steps against climate change and take actions to reduce emissions. Super Energy currently invests over HK$10 billion per year in the development of renewable energy sources and environmental protection.

In June 20X1, because of a gas release, Super Energy's oil rig working on the Bargara exploration well in the Gulf of Sankala exploded. The fire burned for 48 hours before the rig sank and the oil leaked into the Gulf of Sankala for 85 days before the well was closed and sealed. Ten people died in the accident and others were injured. The accident also caused significant damage to the environment and the livelihoods of those in the communities nearby. The accident was widely reported by the media. Super Energy was requested by the US government to investigate and explain the causes of the accident to the public.

The company has committed to take responsibility for the clean-up and compensate victims of the accident. As of 31 December 20X1, the company reported that it has spent HK$20 billion on the response activities.

ABC & Co. is the auditor of Super Energy. ABC & Co. and Super Energy's board of directors meet with the Audit Committee quarterly. ABC & Co. also holds regular meetings with the internal audit and reviews the internal audit investigation reports.

There were two internal audit investigation reports issued in December 20X1 which caused particular concern to ABC & Co. In these reports, they found a significant access control deficiency over the Flex Accounts which are the general ledger used by Super Energy worldwide, and some exploration and production facilities were potentially overstated as certain significant controls over non-current asset registration and valuation were not properly exercised by the operation team.

Here is an extract of the financial data of Super Energy:

	Year ended 31 December 20X1 (Unaudited) HK$ billion	*Year ended 31 December 20X0* (Audited) HK$ billion
Revenue	250	220
Profit / loss before tax	(50)	30
Total assets	3,790	3,856
Total liabilities	2,823	2,998

Question 1 — 32 minutes

(a) Assuming you are ABC & Co., after reading the internal audit report about the potential overstatement of certain exploration and production facilities, evaluate and explain the financial statement assertions that concern you most relating to non-current assets.

(3 marks)

(b) In response to your risk assessment explained in Question 1(a), what audit procedures would you consider in addressing the risk of material misstatements you identified?

(15 marks)

Question 2 — 23 minutes

(a) Assuming you are ABC & Co., in response to the accident in the Gulf of Sankala, identify three risks of material misstatements of Super Energy's financial statement as at 31 December 20X1.

(3 marks)

(b) In response to the risk of material misstatements identified in Question 2(a), suggest and discuss the audit procedures that you would perform in order to address the assessed risk of material misstatements.

(10 marks)

Question 3 — 10 minutes

Assuming you are ABC & Co., in a recent dialogue with the internal audit, you understand that the internal audit has issued an unsatisfactory report on the access control of the Flex Accounts which are the general ledger used by Super Energy worldwide. For risk assessment purposes, what are the additional procedures you would suggest to perform?

(5 marks)

Question 4 — 25 minutes

According to the Code on Corporate Governance Practices in Hong Kong and in response to the accident in the Gulf of Sankala, discuss how the following stakeholders could discharge or perform better their own functional duties and related corporate governance responsibilities towards financial reporting and internal controls:

(a) The board of directors **(6 marks)**

(b) Audit Committee **(4 marks)**

(c) ABC & Co. **(4 marks)**

(Total = 50 marks)

HKICPA June 2012 (amended)

CASE STUDY 3

Dummy Real Estate Investment Trust (DREIT) is a mid-size real estate investment trust listed in Hong Kong. With a portfolio of 50 real estates comprising retail malls, commercial premises and car park facilities, DREIT was established by a trust deed (Trust Deed) – (also refer to Note* below).

DREIT has a manager (Manager) who has the general power to manage DREIT's assets in the interests of its unitholders (Unitholders) in accordance with the Trust Deed. A Board of Directors is responsible for the Manager's overall governance, including establishing targets for executive management and monitoring the achievement of these targets. DREIT's trustee (Trustee) is responsible under the Trust Deed for the safe custody of DREIT's assets and holds the same for and on behalf of the Unitholders. The Manager is independent of the Trustee.

DREIT aims to produce a sustainable stream of income from its portfolio and to maximise the value through the enhancement of its physical built structure, trade-mix, marketing and customer service. As these enhancement projects progress, the portfolio offers customers better shopping facilities with more choices at reasonable prices, whilst improving returns for the Unitholders.

Since its listing on the Hong Kong Stock Exchange in December 20X8, DREIT has been paying the Unitholders at about 90% of its net income and has demonstrated consistent growth in distribution per unit. A substantial portion of the remuneration of DREIT's senior executives is closely linked to the growth rate of the distribution per unit.

Certain DREIT's financial and operating data are set out as follows:

	Year ended 31 December 20Y0	Year ended 31 December 20X9
Revenue	HK$404 million	HK$385 million
Net property income margin	35%	35%
Distribution per unit	49 cents	43 cents
Average monthly unit rent	HK$26 per square foot	HK$26 per square foot
Occupancy rate	91%	87%
Gearing	20%	18%

Mr. Kwok is the audit director of a CPA incorporated practice in charge of the audit of DREIT's financial statements for the year ended 31 December 20Y0.

In April 20Y0, DREIT made an acquisition of a block of low-rise commercial premises in the New Territories. Part of the premises suddenly collapsed in December 20Y0. There was no casualty reported and DREIT's Manager believed that the damages are fully covered by its group insurance policy. However, emerging evidence indicates that there was an illegal extension built on the premises which might have caused the collapse. If it is the case, the damage could be an uninsured loss.

Note *DREIT is a collective investment scheme in the form of a unit trust established by a trust deed, authorised by the Securities and Futures Commission under the Securities and Futures Ordinance and regulated by the provisions of the Code on Real Estate Investment Trusts.

Question 1 — 11 minutes

Define the entity's risk assessment process (which is one of the elements of internal controls) and describe two specific risk assessment processes that Mr. Kwok should expect DREIT has in place to minimise the risks of premises collapse, particularly for those caused by the illegal extension built on the premises. **(6 marks)**

Question 2 — 16 minutes

Define fraud risk factors and identify four fraud risk factors for the purpose of DREIT's audit.

(9 marks)

Question 3 — 25 minutes

DREIT has established an audit committee to comply with the Listing Rules of the Hong Kong Stock Exchange.

Required

(a) To what extent can the establishment of an effective audit committee improve DREIT's corporate governance in the context of external auditing, financial reporting and internal control? **(8 marks)**

(b) Describe some ways to gauge the effectiveness of DREIT's audit committee.

(6 marks)

Question 4 — 27 minutes

Assume that Mr. Kwok's estimate of losses to DREIT following the premises collapse is material for audit purposes but the Manager of DREIT has refused to adjust the financial statements. Against such circumstances of the case, assume that any misstatements are not likely to be pervasive to DREIT's financial statements.

Required

(a) Identify and discuss the most appropriate form of audit opinion. **(7 marks)**

(b) Assume that you are Mr. Kwok and have decided to modify the audit opinion. Write a draft report comprising the report title, the basis of opinion, the qualified opinion and the report issuer sections ONLY. **(8 marks)**

Question 5 — 11 minutes

The tenancy of Mr. Kwok's CPA practice office will expire in November 20Y1. Mr. Kwok has been offered by DREIT a two-year tenancy in one of its prime commercial premises at a monthly rent of HK$10 per square foot with an initial three-month rent-free period.

Required

Briefly discuss the ethical issues that Mr. Kwok and his CPA practice face in the above situation, and suggest the appropriate action for Mr. Kwok. **(6 marks)**

(Total = 50 marks)

HKICPA December 2011 (amended)

CASE STUDY 4

ABC is a popular German brand department store targeting young couples and the mid-level income group. It currently operates three shops in Hong Kong. Its parent company is listed in Germany and has a plan to expand its operations from Hong Kong by opening more stores.

Because of its expansion plan, ABC engaged T&T, an external consultant in Hong Kong, to perform a thorough operational efficiency review for ABC, in particular for sales and purchase processes and related IT support.

The T&T report suggested ABC should change to a more sophisticated SAP system, a business management software, to support their future business needs. In this regard, ABC implemented a new tailored SAP system called "SUCCESS" on 1 July 20Y0.

In addition, T&T also suggested ABC change its inventory costing method from the retail costing method to the weighted average costing method as the weighted average costing method represents a more reliable accounting estimate than the retail costing method. Accordingly, ABC has changed its inventory costing method since 1 July 20Y0 upon the launch of "SUCCESS". The inventory costing is calculated automatically by "SUCCESS". The inventory report is prepared for management review twice a week.

Moreover, T&T also performed a thorough review of ABC's available human resources and commented that ABC has insufficient expertise to manage its expansion.

In this regard, ABC hired a new general manager in February 20Y0, Mr Thomas Chan, who has over 20 years of experience in consumer retailing. He is in charge of the ABC expansion project and the system implementation.

B & Co has been the auditor of ABC for the past 15 years and Mr Ben Bee and Miss Julie Chan have been the partner-in-charge and manager-in-charge of the ABC audit in the last three years.

Thomas is Julie's uncle. Thomas understands Julie has been working on ABC's audit and she is familiar with ABC's operation flows. Therefore, he has been reaching out to Julie for assistance on certain system designs and user implementation testing because ABC does not have sufficient manpower to support its expansion.

Below is the extract of ABC's financial statements:

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20Y0

	20Y0 (Unaudited)	20X9 (Audited)
	HK$'000	HK$'000
Revenue	2,450,720	2,170,360
Gross profit %	48%	44%
Profit for the year	95,416	80,070

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20Y0

	20Y0 (Unaudited)	20X9 (Audited)
	HK$'000	HK$'000
Current assets		
Inventories	92,058	120,691
Trade and other receivables	38,424	33,705
Cash and cash equivalents	420,629	350,415
Current liabilities		
Trade and other payables	220,322	210,655

Question 1 — 18 minutes

Assume that you are Julie, you are going to discuss with Ben the ABC audit arrangement for 20Y0. Refer to the facts of above, what independence issue(s) would you consider for advising Ben for his consideration on whether B & Co should continue the external auditor relationship with ABC for 20Y0? And what safeguard(s) would you recommend to Ben?

(10 marks)

Question 2 — 22 minutes

Assume that B & Co has been re-appointed as ABC's external auditor for 20Y0 and was not engaged by ABC to assist on system design and implementation.

Required

With respect to the audit of ABC's financial statements for the year ended 31 December 20Y0, explain the impact of the SAP implementation on the audit in terms of:

(i) audit planning

(ii) IT general and application controls; and

(iii) data integrity, and outline the appropriate audit procedures.

(12 marks)

Question 3 — 18 minutes

ABC has a business relationship with over 5,000 local and overseas suppliers. With respect to the audit of ABC's financial statements for the year ended 31 December 20X9, B & Co arranged accounts payable confirmations. Some of the confirmation replies from the suppliers indicated that the confirmed balance did not agree with suppliers' record but could be reconciled and explained by ABC.

In April 20Y0, as instructed by Thomas, the accounts payable team implemented a new process. They now perform reconciliations to monthly statements from overseas suppliers, and any variance is properly followed up by the accounts payable team and approved by Thomas.

Required

(a) Evaluate and explain the risk of material misstatement relating to the completeness assertion of ABC's accounts payable as at 31 December 20Y0. **(3 marks)**

(b) Suggest the audit procedures you would perform in response to the assessed risk of material misstatement relating to the completeness assertion of ABC's accounts payable as at 31 December 20Y0. **(7 marks)**

Question 4 — 32 minutes

There are over 100,000 inventory items amounting to over HK$33 million as at 31 December 20Y0. Management perform a year-end inventory count on 15 and 16 December 20Y0. Thomas directly supervises the year-end inventory count with the assistance of the accounting department. Management reconcile the physical count records to inventory sub-ledger, investigate the difference and correct the sub-ledger balance as appropriate.

Required

(a) What are the factors and procedures which should be considered in planning the physical count on existence assertion of ABC's inventories as at 31 December 20Y0? **(7 marks)**

(b) In view of the implementation of "SUCCESS" and change of the inventory costing method, evaluate and explain the risk of material misstatement relating to the accuracy and completeness assertion of ABC's inventories as at 31 December 20Y0. **(4 marks)**

(c) Suggest the audit procedures you would perform in response to the assessed risk of material misstatement relating to ABC's inventories as at 31 December 20Y0 as described in Question 4(b)? **(7 marks)**

(Total = 50 marks)

HKICPA June 2011 (amended)

CASE STUDY 5

Day and Night (D&N) is a firm of Certified Public Accountants (Practising) and has recently been approached by A Dummy Limited (ADL) in respect of a change of its statutory auditor. In considering the audit nomination, D&N has been given the audited financial statements for the year ended 31 March 20X9 and the unaudited management accounts for the nine-month period ended 31 December 20X9, of which certain key figures are detailed as follows:

ADL's statement of profit or loss and other comprehensive income

	Unaudited management accounts (9 months ended 31 December 20X9)	Audited financial statements (Year ended 31 March 20X9)
	HK$'000	HK$'000
Revenue	103,985	152,495
Gross Profit	30,294	49,493
Profit before tax	10,604	16,956

ADL's statement of financial position

	Unaudited management accounts (9 months ended 31 December 20X9)	Audited financial statements (Year ended 31 March 20X9)
	HK$'000	HK$'000
Non-current assets	106,166	94,507
Current assets	78,324	73,611
Current liabilities	(79,302)	(74,247)
Non-current liabilities	(10,958)	(10,245)

ADL is a private company in the business of producing Chinese nutritious food and was established by its owner, Mr Chan, about twenty years ago. Mr Chan, aged 70, is still active in running ADL, but he would like to retire in the next two to three years. As none of Mr Chan's children is interested in succeeding him in running the business, he would like to sell ADL to some business partners or investors. Mr Chan has not yet decided on the most appropriate form of partnership or capitalisation arrangement, but he has plans to utilise any funding injection as the company's working capital. Some institutional investors have already expressed their interest and have made some enquiries about the company's business.

There was a longstanding lawsuit against ADL at the High Court in respect of a violation of some intellectual property rights. ADL lost the case in November 20X9 and was ordered to pay compensation of HK$50,000,000. The compensation has not yet been paid. A provision of HK$30,000,000 has been made in the financial statements and management accounts. Mr. Chan is in discussion with the lawyers regarding an appeal against the judgment.

Mr Chan has asked D&N to consider charging the audit fee based on the amount of ADL's reported profit for the year ended 31 March 20Y0.

Question 1 — 22 minutes

(a) Discuss the policies and procedures that D&N should have in place in considering ADL's audit nomination. **(5 marks)**

(b) Discuss the ethical requirements on D&N in respect of ADL's audit nomination and change in auditor. **(7 marks)**

Question 2 — 16 minutes

Assume that D&N has accepted the audit engagement. Nancy is D&N's engagement partner on ADL's audit and has made an assessment of the risk of material misstatement at the financial statement level due to fraud as low.

Required

(a) Define the risk of material misstatement at the financial statement level. **(1 mark)**

(b) As the audit manager of D&N, explain to your trainees:

(i) how Nancy's assessment of the risk of material misstatement at the financial statement level due to fraud as low was formed; and

(ii) D&N's overall response and the relevant audit procedures in response to such an assessment. **(8 marks)**

Question 3 27 minutes

(a) Briefly explain how Nancy should consider the going concern assumption in ADL's financial statements. **(2 marks)**

(b) Identify and discuss examples of events or conditions which may invalidate the going concern assumption in ADL's financial statements. **(13 marks)**

Question 4 25 minutes

In the process of finalising the auditor's report on ADL's financial statements for the year ended 31 March 20Y0, Nancy is considering the effect of subsequent events on ADL's financial statements and the auditor's report.

Required

(a) Briefly explain the meaning of subsequent events. **(2 marks)**

(b) Discuss the specific audit procedures that Nancy and her engagement team should perform in identifying the events that may require adjustments of ADL's financial statements for the year ended 31 March 20Y0. **(12 marks)**

(Total = 50 marks)

HKICPA December 2010 (amended)

CASE STUDY 6

Hong Kong Bauhinia Development Company Limited is a company listed on the Stock Exchange of Hong Kong Limited ("the Stock Exchange").

Hong Kong Bauhinia Development Company Limited and its subsidiaries ("HKB") are principally engaged in property investment, management and development. Through decades of development, HKB has created one of Hong Kong's best known commercial districts in North Bay, which is home to the regional offices of many well-known multinational corporations such as ABC Group, famous retail chain shops such as MBC Retail Chain, and a collection of food, beverage and entertainment outlets with unique themes such as Brazil Coffee Cafe. HKB is the largest commercial landlord in North Bay and has a well-balanced portfolio of superior investment properties. HKB has a quality client base with prominent multinational and strong local tenants, and does not unduly depend on any particular type of tenant.

HKB's Corporate Governance Guidelines provide for separate roles for the Chairman and Chief Executive Officer. Mr Raymond Lee serves as the Chairman and Mr Samuel Ho serves as the Chief Executive Officer. HKB also meets other requirements of the Code Provisions contained in the Code on Corporate Governance Practices set out in Appendix 14 of the Rules Governing the Listing of Securities on the Stock Exchange ("Listing Rules").

To HKB, good corporate governance is not just an exercise in compliance with the Listing Rules. In its quest to deliver long-term sustainable value to its shareholders, HKB understands the context in which the company operates and makes decisions that balance the needs of various stakeholders. To HKB's shareholders, this is translated into a commitment to maintaining the highest standards of corporate governance. The cornerstones of HKB's corporate governance practices are accountability, transparency, and integrity.

HKB has a strong tradition of good corporate governance and a corporate culture based on good business ethics and accountability. HKB has a formal Code of Ethics that is communicated to all staff, all of whom are expected to comply with the code all the time. HKB has also established a "whistle-blowing" system aiming at preventing and detecting fraud or suspected fraud. The "whistle-blowing" system is administered by an independent third party service provider which can directly report to the Chairman of the Audit Committee. HKB aims to build risk awareness and control responsibility into its culture and regards this as the foundation of its internal controls system.

As Chairman, on various occasions, Mr Lee has stated clearly that HKB aims to be a financially successful as well as responsible business. He is very proud of HKB being able to contribute to society through its normal business activities, including the areas of environment and health and safety, and by active participation in community activities. For example, HKB has been a strong supporter of the Hong Kong Government's Wastewise Scheme since its inception, and requests all HKB contractors to use eco-friendly cleaning equipment and products within HKB's portfolio of buildings.

In the fourth quarter of 20X8, the emergence of the global financial tsunami led to volatility in most financial markets and a contraction in the supply of credit. In Hong Kong, worsened economic conditions decreased the demand for leased commercial properties and intensified competition among landlords. In response, HKB has been adopting prudent financial policies such as making advance arrangements for debts to be re-financed in 20Y1 and further strengthening its financial and treasury management, budgeting planning and costs control systems.

On initial recognition, HKB measures its investment properties at cost. Subsequent to initial recognition, HKB measures its investment properties at their fair values using the fair value model. HKB derecognises an investment property upon disposal or when the investment property is permanently withdrawn from use or no future economic benefits are expected from its disposals.

HKB did not have any active development projects during the years ended 31 March 20Y0 and 20X9. As at 31 March 20Y0, all of HKB's investment properties were located in Hong Kong. The turnover and income of HKB are principally derived from the leasing of investment properties located in Hong Kong. Despite worsened economic conditions in Hong Kong in early 20X9, HKB still maintains a sustainable income with high occupancy consistently achieved (close to 100% even for the year ended 31 March 20Y0) and the average lease term is much longer than its competitors. Revenue is measured at the fair value of the consideration received or receivable. Rental income is recognised on a straight-line basis over the term of the relevant lease.

HKB's consolidated statements of financial position at 31 March 20Y0 and 20X9 are as follows:

(HK$'000)	20Y0 (unaudited)	20X9 (audited)
Investment properties	35,500,241	35,437,223
Property, plant and equipment	76,100	71,327
Prepaid lease payments	134,000	134,000
Investment in associates	1,613,258	1,112,255
Available-for-sale investments	1,077,304	2,489,429
Other financial assets	15,309	14,391
Non-current assets	38,416,212	39,258,625
Accounts receivable and other receivables	85,880	64,600
Amount due from an associate	30,120	30,120
Other financial assets	35,000	20,850
Cash and cash equivalents	1,072,204	528,516
Current assets	1,223,204	644,086
Total assets	39,639,416	39,902,711

(HK$'000)	20Y0 (unaudited)	20X9 (audited)
Share capital	5,120,200	5,053,187
Reserves	25,810,300	26,750,206
Non-controlling interests	1,141,002	1,090,581
Total equity	32,071,502	32,893,974
Accounts payable and accruals	330,800	290,322
Rental deposits from tenants	160,606	132,000
Taxation payable	360,500	280,266
Current liabilities	851,906	702,588
Borrowings	3,100,244	2,322,292
Other financial liabilities	40,508	18,290
Rental deposits from tenants	220,020	205,000
Deferred taxation	3,355,236	3,760,567
Non-current liabilities	6,716,008	6,306,149
Total liabilities	7,567,914	7,008,737
Total equity and liabilities	39,639,416	39,902,711

HKB's consolidated statements of profit or loss for the year ended 31 March 20Y0 and 20X9 are as follows:

(HK$'000)	20Y0 (unaudited)	20X9 (audited)
Revenue	1,790,453	1,498,287
Property expenses	(237,196)	(229,286)
Gross profit	1,553,257	1,269,001
Investment income	60,122	95,066
Other gains and losses	150,898	300,425
Administrative expenses	(140,600)	(105,524)
Finance costs	(150,942)	(176,200)
Change in fair value of investment properties	(220,200)	3,222,352
Share of results of associates	595,000	440,426
Profit before taxation	1,847,535	5,045,546
Income tax expense	(1,300)	(772,967)
Profit for the year	1,846,235	4,272,579
Profit due to the parent	1,712,979	3,888,047
Due to non-controlling interests	133,256	384,532
Profit for the year	1,846,235	4,272,579

Question 1 — 14 minutes

ABC & Co ("ABC") has been HKB's external auditor for the past ten years and Mr Simon Lam and Mr Tony Lee have been the lead engagement partner and partner-in-charge of the engagement quality control review of the HKB audit respectively for the past seven years. During its June 20X9 meeting, HKB's Audit Committee resolved to recommend to HKB's Board of Directors that the shareholders be asked to re-appoint ABC as HKB's external auditor for 20Y0.

Required

Discuss the independence issues ABC should consider in determining whether to accept HKB's re-appointment as HKB's external auditor for 20Y0. **(8 marks)**

Question 2 — 45 minutes

Assume that ABC has been re-appointed as HKB's external auditor for 20Y0 after it reported on HKB's financial statements for the year ended 31 March 20X9.

Required

With respect to the audit of HKB's financial statements for the year ended 31 March 20Y0:

(a) assess the risk of material misstatement at the financial statement level; and **(13 marks)**

(b) design further audit procedures to examine the valuation and allocation assertion of investment properties as at 31 March 20Y0. **(12 marks)**

Question 3 — 13 minutes

Assume that you are the lead engagement partner in charge of the audit of HKB's financial statements for the year ended 31 March 20Y0. Jimmy, a CPA and an audit team member of HKB's 20Y0 audit, has just informed you that he has inherited one million shares (representing 0.01% of the total outstanding ordinary shares) of HKB's ordinary shares due to the sudden death of his rich uncle.

Required

Comment on the impact of this new information on the independence status of ABC as HKB's external auditor. What actions should ABC undertake? **(7 marks)**

Question 4 — 18 minutes

Susan, an audit senior at ABC, is in the audit team of HKB. You are the lead engagement partner in charge of the audit of HKB's financial statements for 20Y0. As one of your mentees, Susan had a lunch with you last week talking through a few matters including some of her work queries and her balance between work and family life.

Susan told you that she would be involved in the audit of HKB's financial statements for the year to 31 March 20Y0 and that, as far as she could recall, HKB had material banking activities and held a total of ten bank accounts with different banks. After obtaining an understanding of HKB and its environment (including its internal control) sufficient to identify and assess the risks of material misstatement of the financial statements, certain substantive procedures would be performed.

Susan asked you whether or not she could avoid sending bank confirmation requests to those banks of which the accounts were closed by HKB during the year. Susan also queried if it would be possible to agree the bank statement balance to the bank reconciliation, as an alternative audit procedure to receiving the bank confirmation from the bank.

Required

(a) List five audit steps that Susan should take when performing substantive procedures (tests of details) on the year end bank reconciliation. **(5 marks)**

(b) Identify two possible mistakes in Susan's conversation. Explain the impact of such mistakes to the quality of audit and recommend appropriate actions. **(5 marks)**

(Total = 50 marks)

HKICPA February 2010 (amended)

CASE STUDY 7

Hong Kong Manufacturing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Manufacturing Company Limited and its subsidiaries ("HKM") are principally engaged in the manufacture and distribution of garment and apparel products. All HKM's production facilities are located in Mainland China. HKM's operating results in the last five years are summarised as follows:

	20X8 HK$'m (Draft)	20X7 HK$'m	20X6 HK$'m	20X5 HK$'m	20X4 HK$'m
Revenue	3,322	2,488	2,045	1,368	975
Operating profit	400	353	349	167	56
Profit after tax	335	283	255	132	33

The draft summary of the financial position of HKM as at 31 December 20X8 is as follows:

	20X8	*20X7*
	HK$'m	HK$'m
Intangible assets	150	52
Property, plant and equipment	547	446
Other non-current assets	42	86
Inventories	486	282
Trade and other receivables	704	479
Bank balances and cash	580	567
Other current assets	106	36
Total assets	2,615	1,948
Equity	1,903	1,556
Long-term bank loans	14	7
Taxation payable	79	49
Bank overdrafts	68	11
Trade and bills payable	377	228
Accruals and other payables	174	97
Total equity and liabilities	2,615	1,948

You are a manager at XYZ & Co., HKM's auditor since its listing in 20X6. You are the manager-in-charge of the audit of HKM's financial statements for the year ended 31 December 20X8.

Question 1 — 22 minutes

You are giving a pre-audit meeting briefing to your team members.

Required

Explain the responsibility of the engagement team/partner in complying with the quality control requirements:

(a) in engagement acceptance;
(b) during engagement performance; and

(c) before issuing the auditor's report on HKM's 20X8 financial statements. **(12 marks)**

Question 2 — 24 minutes

Your team assessed the inherent risks of material misstatement at the assertion level of revenue from sales of goods as normal for all assertions and were able to rebut the presumed risk of fraud in revenue recognition. After taking into consideration the design and implementation of HKM's internal controls over revenue transactions, your team assessed the risks of material misstatement at the assertion level as low for all assertions with an expectation of the operating effectiveness of the internal controls. You instruct your assistants to perform tests of details on a sample of sale transactions for the occurrence of sale transactions, concurrently with tests of controls on revenue transactions to confirm your team's expectation of the operating effectiveness of the internal controls.

Required

(a) Determine how the sample size for the tests of details would be affected:

  (i) by audit materiality at a given level of assessed risk; and
  (ii) the assessed low risk at a given level of audit materiality. **(6 marks)**

(b) Determine how your team should respond if the delivery notes and customer invoice for one of the sample units were found missing and the client was not able to locate the missing documents. **(7 marks)**

Question 3 — 21 minutes

Mr. Lee, the Managing Director of HKM, has asked your team to rely on some of the work which is regularly performed or will be performed by HKM's internal auditors for the purpose of carrying out the audit of HKM's 20X8 financial statements. Particularly, Mr Lee has suggested your team to rely on the following work, which is regularly performed or will be performed by HKM's internal auditors:

(i) year-end physical inspection of the property, plant and equipment; and

(ii) on-going monitoring activities of the completeness of acquisition of merchandise from suppliers.

Required

(a) When your team intends to use the work of HKM's internal auditors, how would your team evaluate their work? **(4 marks)**

(b) Explain whether your team would use the work of HKM's internal auditors in the specific ways suggested by Mr. Lee. **(8 marks)**

Question 4 — 23 minutes

Included in HKM's accruals and other payables of HK$174,000,000 at 31 December 20X8 is an estimate of losses from a personal injury claim against the company in the amount of HK$4,305,200. You are checking the adequacy of this provision.

Required

Explain the main approaches with detailed steps in auditing the adequacy of this HK$4,305,200 provision, quoting the relevant auditing standard where applicable. **(13 marks)**

(Total = 50 marks)

HKICPA May 2009

CASE STUDY 8

Established 15 years ago, ZZZ Holdings Limited ("ZZZ") is a listed company on the Main Board of the Hong Kong Stock Exchange. ZZZ's primary business is the manufacture and sale of a wide range of decorative and entertainment lighting. ZZZ has over 6,000 employees and four factories in Mainland China.

Ms. Apple Au is the founder (and the Chief Executive Officer) of ZZZ and has always placed a great emphasis on innovation, quality control and quality assurance. ZZZ has more than 50 research engineers and develops over one hundred new models each year. ZZZ also has a broad portfolio of patented products and is constantly developing more innovative products with more advanced technology.

In May 20X8, ZZZ's previous auditor (Red and Blue) retired and declined to stand for re-appointment after reporting on the financial statements for the year ended 31 December 20X7 in ZZZ's annual general meeting.

In August 20X8, Ms. Au invited Ms. Orange Or's firm (Gold and Silver) to be the new auditor. Ms Au had met Ms Or (an audit partner of Gold and Silver) through her secondary school alumni dinner in 20X7.

Gold and Silver has recently been engaged in three initial public offering exercises and is very short of manpower. Ms. Or is in the process of assessing this prospective engagement. ZZZ's Accounting Manager has provided Ms. Or with the audited financial statements for the year ended 31 December 20X7 and the unaudited management accounts for the eight months ended 31 August 20X8. Ms. Or has extracted certain figures from the financial statements and management accounts for analysis as follows:

Statement of profit or loss

	Extracted from management accounts	Extracted from audited financial statements
	(1 January 20X8 to 31 August 20X8)	(Year ended 31 December 20X7)
	HK$'000	HK$'000
Revenue (Note 1)	700,459	802,009
Gross profit	100,237	170,394
Net profit before tax	72,004	71,370

Statement of financial position

	Extracted from management accounts	Extracted from audited financial statements
	(at 31 August 20X8)	(at 31 December 20X7)
	HK$'000	HK$'000
Inventories	340,501	231,092
Accounts receivable (Note 2)	287,094	197,290
Impairment of receivables	(2,000)	(2,000)
Current assets	901,294	725,190
Net assets	792,029	401,921
Total assets	1,592,091	800,284

Note 1: Monthly analysis of sales revenue

	20X8	20X7
	HK$'000	HK$'000
January	81,039	64,612
February	98,156	65,516
March	97,209	65,201
April	96,411	67,503
May	81,039	65,027
June	82,919	67,287
July	83,493	70,383
August	80,193	69,008
September	0	70,182
October	0	67,263
November	0	63,243
December	0	66,784

Note 2: Ageing analysis of accounts receivable

	Extracted from management accounts (at 31 August 20X8)	Extracted from audited financial statements (at 31 December 20X7)
Age	HK$'000	HK$'000
0 to 60 days	105,517	115,090
61 to 90 days	62,908	37,001
91 to 180 days	57,984	36,219
181 to 365 days	38,980	8,980
Over 1 year	21,705	0
	287,094	197,290

Question 1 — 32 minutes

(a) Briefly explain the procedures (other than the independence consideration) Gold and Silver should carry out before the acceptance of Ms Au's invitation. **(6 marks)**

(b) Following on from part (a) above, explain how Ms Or should assess the integrity of Ms Au and the key management of ZZZ. **(6 marks)**

(c) Explain the ethical obligations of Gold and Silver regarding the change in auditors. **(6 marks)**

Question 2 — 26 minutes

Assume that Gold and Silver has accepted the audit engagement.

(a) Evaluate the risk of material misstatement relating to the existence assertion of ZZZ's inventories as at 31 December 20X8. **(3 marks)**

(b) Explain the audit procedures Ms Or should perform in response to the assessed risk of material misstatement relating to the existence assertion of ZZZ's inventories as at 31 December 20X8. **(6 marks)**

(c) Discuss Gold and Silver's responsibilities regarding the carrying amount of ZZZ's inventories as at 31 December 20X7. **(5 marks)**

Question 3 — 14 minutes

Assume that Gold and Silver has accepted the audit engagement. In mid-December 20X8, Ms Au left a telephone message for Ms Or enquiring about the auditor's view of the adequacy of the HK$ 2 million impairment of receivables on ZZZ's financial statements. Before returning the call, briefly explain what Ms Or should consider in relation to this inquiry. **(8 marks)**

Question 4 — 18 minutes

ZZZ also appointed Gold and Silver to review and report on the interim financial report of ZZZ for the six months ended 30 June 20X8.

Required

(a) How does a review of an interim financial report differ from an audit of financial statements? **(3 marks)**

(b) Explain Gold and Silver's responsibility for other information that accompanies ZZZ's interim financial report. **(7 marks)**

(Total = 50 marks)

HKICPA September 2008 (amended)

CASE STUDY 9

Hong Kong Printing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Printing Company Limited and its subsidiaries ("HKP") are principally engaged in the manufacture and printing of multi-colour packing products, boxes, books, brochures and other paper products. All HKP's production facilities are located in Mainland China.

20X7 was a very difficult year for HKP. HKP reported a loss, for the first time since its incorporation 30 years ago, of HK$23 million. The loss was caused by a drop in sales due to intense market competition, coinciding with increases in variable costs in raw materials and wages.

HKP's operating results in the last five years are as follows:

	20X7	20X6	20X5	20X4	20X3
	HK$'000	HK$'000	HK$'000	HK$'000	HK$'000
Revenue	423,044	471,222	435,421	451,420	425,345
Operating profit/(loss)	(5,371)	14,312	32,265	28,759	24,487
Finance costs	(8,889)	(7,975)	(10,521)	(10,879)	(12,038)
Profit/(loss) after tax	(23,151)	3,973	16,999	11,118	8,355

Because of the unexpectedly poor operating results, HKP experienced extremely severe operating cash flow problems during the year. HKP delayed paying interest to its major banks in accordance with the loan agreements. As a result of these breaches of covenants, the bank loans became repayable immediately. HKP's management obtained informal understandings from the relevant account managers of the banks that in view of the long term relationship with HKP the banks would not require HKP to repay the loans immediately. However, no formal confirmation of these waivers had been obtained from the banks. The management of HKP was not aware of the financial reporting requirement to reclassify such loans as current when they prepared the draft financial statements for the year ended 31 December 20X7.

The draft consolidated statement of financial position of HKP as at 31 December 20X7 is as follows:

	20X7	20X6
	HK$'000	HK$'000
Pre-paid land lease premium	30,695	31,202
Property, plant and equipment	409,339	350,359
Non-current assets	440,034	381,561
Inventories	78,788	106,259
Trade and other receivables	85,555	104,443
Bank balances and cash	33,918	48,060
Current assets	198,261	258,762
Total assets	638,295	640,323
Share capital	22,255	22,255
Reserves	221,579	244,730
Equity	243,834	266,985
Long-term bank loans	234,120	231,734
Deferred tax liabilities	19,170	20,653
Other non-current liabilities	901	1,210
Non-current liabilities	254,191	253,597
Taxation payable	1,219	1,827
Current portions of long term bank loans	25,278	23,956
Bills payable	49,516	37,772
Trade and other payables	64,257	56,186
Current liabilities	140,270	119,741
Total equity and liabilities	638,295	640,323

You are a manager at XYZ & Co, HKP's auditor since its incorporation. You have been the manager-in-charge of audits of HKP's financial statements for the last five years.

Question 1 — 23 minutes

You are performing certain preliminary engagement activities for the audit of HKP's financial statements for the year ended 31 December 20X7 ("20X7 audit"), including the development of an overall audit strategy, and an assessment of the risk of material misstatement at the financial statement level.

Required

Determine:

(a) the ethical issues your team should consider in deciding whether your firm should continue the client relationship with HKP and accept the 20X7 audit engagement; and **(6 marks)**

(b) the overall response and any relevant audit procedures in response to your preliminary assessment that the risk of material misstatement at the financial statement level due to fraud and error is low. **(7 marks)**

Question 2 — 27 minutes

You consider that the whole amount of long-term bank loans in HKP's draft consolidated statement of financial position should be reclassified as a current liability. After you raised this issue to the management of HKP, they obtained formal confirmation of the waivers from the banks for the breaches of covenants in 20X7 and have disclosed the details of the breaches and waivers in Note 1(c) of the revised draft of financial statements. On this basis, the management of HKP disagreed with your request to reclassify the loans as current. Also, the engagement partner is unsure of the correctness of your proposed re-classification because he remembered a similar case a few years ago which did not necessitate re-classification under the accounting standards applicable at that time.

Required

Regarding the proper classification of bank loans as current and non-current:

(a) assess the risk of material misstatement at the assertion level; **(3 marks)**

(b) explain whether your audit approach in this particular case may be different from a typical situation, and determine the further audit procedures you would perform in response to the assessed risk; and **(8 marks)**

(c) determine how your team would resolve the differences in opinion amongst team members and with HKP in accordance with the quality control standards. **(4 marks)**

Question 3 — 18 minutes

In auditing HKP's financial statements for the last year, you have assessed the risk of material misstatement of all the assertions of HKP's trade and other payables as low, with the expectation that HKP's controls over trade and other payables are operating effectively and have performed tests of controls to confirm your expectation.

Required

Regarding the completeness of trade and other payables of HKP's financial statements for the current year:

(a) assess the risk of material misstatement at the assertion level; and **(3 marks)**

(b) determine the most efficient audit approach and briefly describe the further audit procedures your team would perform in response to the assessed risk.

[For the purpose of this part, you should determine the audit approach, discuss the timing of the further audit procedures and give not more than three examples of further audit procedures you would perform.] **(7 marks)**

Question 4 — 22 minutes

Assume that HKP finally reclassified the bank loans as current liabilities.

Required

(a) Determine whether the use of the going concern assumption in this case is appropriate. Explain the procedures you would perform before coming up with your conclusion; and **(7 marks)**

(b) Advise the engagement partner of any modification your firm should make in the auditor's report and draft the modification. **(5 marks)**

(Total = 50 marks)

HKICPA February 2008 (amended)

CASE STUDY 10

Engineering Materials Manufacturing Company Limited is a company listed on the Hong Kong Stock Exchange.

Engineering Materials Manufacturing Company and its subsidiaries ("EMM") are principally engaged in the manufacture and trading of engineering materials, including steel, iron, aluminium, cement, timber and asphalt. EMM's customers are mainly construction and engineering companies in Mainland China, Hong Kong and other Asian countries. As at 31 December 20X6, over 90% of EMM's assets were located in Mainland China.

In view of the booming economy in Mainland China, EMM embarked on an expansion plan two years ago to double the group's revenues within five years. EMM plan to implement this strategy through acquisition of other manufacturers as well as setting up new plant in strategic locations in the Mainland. In the last two years, an increasing trend in sales and receivables has been noted.

On 21 December 20X6, EMM succeeded in issuing debentures of US$130,000,000 at an interest rate of 9.5% per annum. The debentures are listed on an overseas exchange. The proceeds received were used partly to repay bank loans when they were due, while the remaining cash was kept in banks in Mainland China.

EMM's previous auditor, XYZ & Co, was re-appointed in April 20X6 after it reported on EMM's financial statements for the year ended 31 December 20X5. However, XYZ & Co resigned in November 20X6.

XYZ & Co had proposed a fee which doubled the fee it charged EMM in the last year but EMM did not accept the increment. According to EMM, they wanted to change auditors periodically to ensure independence. According to XYZ & Co, the firm is prepared to rotate the engagement partner in accordance with quality control standards.

The directors of EMM approached ABC & Co in January 20X7 and proposed to appoint them as the auditor of EMM's financial statements for the year ended 31 December 20X6.

(i) EMM's consolidated statement of financial position at 31 December 20X6 is as follows:

	20X6	20X5
	HK$'000	HK$'000
Property, plant and equipment	515,661	476,838
Lease premium on land	176,140	45,208
Intangible assets	8,862	4,773
Goodwill	14,086	14,086
Prepayments and deposits	168,442	84,144
Deferred tax assets	15,309	14,391
Non-current assets	898,500	639,440
Current portion of lease premium on land	3,819	1,067
Inventories	80,931	87,143
Trade receivables	936,370	817,126
Cash and cash equivalents	1,220,018	1,064,385
Current assets	2,241,138	1,969,721
Total assets	3,139,638	2,609,161
Share capital	423,835	423,835
Share premium and reserves	910,425	805,075
Non-controlling interests in assets & liabilities	132,731	76,314
Equity	1,466,991	1,305,224
Long-term borrowings	98,833	463,266
Long-term notes	940,636	–
Deferred tax liabilities	1,555	2,298
Non-current liabilities	1,041,024	465,564
Trade and other payables	115,473	151,593
Short-term borrowings	455,509	496,910
Current portion of long-term borrowings	43,333	168,513
Current tax liabilities	17,308	21,357
Current liabilities	631,623	838,373
Total liabilities	1,672,647	1,303,937
Total equity and liabilities	3,139,638	2,609,161

(ii) An analysis of the trade receivables is as follows:

	20X6	20X5
	HK$'000	HK$'000
Within 60 days	533,253	585,004
Between 61 days to 180 days	395,030	206,082
Over 180 days	8,087	26,040
	936,370	817,126
Industry data:		
Revenue/receivables	4.67 times	4.56 times
Receivables turnover (days)	78	80

EMM normally grants 60 days, credit to its customers.

(iii) EMM's consolidated statement of profit or loss for the year ended 31 December 20X6 is as follows:

	20X6	20X5
	HK$'000	HK$'000
Revenue	3,044,505	2,832,638
Cost of sales	(2,722,517)	(2,487,302)
Gross profit	321,988	345,336
Other revenue	9,111	11,098
Other operating gains (net of losses)	2,898	10,423
Distribution and selling expenses	(11,605)	(5,837)
Administrative expenses	(79,849)	(80,222)
Other operating expenses	(2,724)	(12,695)
Profit from operations	239,819	268,103
Finance costs	(73,970)	(31,484)
Profit before taxation	165,849	236,619
Income tax expense	(27,273)	(41,300)
	138,576	195,319
Attributable to shareholders of EMM	116,979	174,760
Non-controlling interests in profit or loss	21,597	20,559
	138,576	195,319

You are ABC & Co's audit manager.

Question 1 — 22 minutes

(a) Determine XYZ & Co's ethical obligations in relation to the change in auditors. **(6 marks)**

(b) Identify issues or conditions surrounding this potential engagement that your firm would consider as indicating a higher risk of material misstatement at the financial statement level. **(6 marks)**

Question 2 — 18 minutes

Your firm has accepted the engagement and you have been appointed as the manager-in-charge of the EMM audit.

(a) Perform analytical procedures to obtain an understanding and, where appropriate, assess the risks of material misstatement at the assertion level of EMM's trade receivables. **(6 marks)**

(b) Suggest four possible causes for further analysis or inquiry after you have performed the above analytical procedures. **(4 marks)**

Question 3 — 27 minutes

You assessed the risk of material misstatement of the existence of EMM's cash and cash equivalents as medium, with an expectation that EMM's internal controls operated effectively during the period.

(a) Determine the audit approach you would adopt to examine the existence of EMM's cash and cash equivalents. **(3 marks)**

(b) List two control activities and two monitoring of controls relevant to the existence of EMM's cash and bank balances that you would expect to have been implemented. **(4 marks)**

(c) For each of the control activities and monitoring of controls you mentioned in (b), suggest an appropriate test of control. **(4 marks)**

(d) Determine any substantive procedures you would perform to examine the existence of EMM's cash and cash equivalents. **(4 marks)**

Question 4 — 23 minutes

A few days before EMM's directors approved the financial statements for the year ended 31 December 20X6, your team's enquiries identified the fact that the general manager of one of the subsidiaries in EMM had misappropriated cash of HK$ 30 million.

Determine implications to your audit and the actions your team would take in response to this situation. **(13 marks)**

(Total = 50 marks)

HKICPA May 2007 (amended)

Question bank – answers

CASE STUDY 1 (December 2012)

Answer 1

(a) As ABC & Co. is the auditor of CCC, consideration of whether or not to act as the single expert should be made with reference to the possible impacts on ethical issues relating to the audit engagement.

The single expert's valuation will indicate a fair value of CCC's equity which could possibly form the basis for the 1st Daughter to buy the 2nd Daughter's equity. As the valuation will affect a transaction between the two shareholders rather than CCC itself, the financial statements may not be materially affected.

Under the Code of Ethics for Professional Accountants, ABC & Co. should assess the levels of self-review threat, self-interest threat, familiarity threat, advocacy threat and intimidation threat. ABC & Co. should be able to accept the engagement if such threats can be maintained at an acceptably low level.

Self-review threat may be created as the valuation exercise may rely on audited financial statements. However, the valuation exercise will take into account many other factors beyond the audited financial statements.

If the single expert's valuation is to be adopted in CCC's financial statements (which is not likely in this case) which are subsequently subject to ABC & Co.'s audit, a self-review threat arises.

Self-interest threat and familiarity threat may be created if Mr. Au or his team have a close relationship with CCC's shareholders, directors or senior management.

An advocacy threat may be created if the fair value from the valuation is adopted in litigation when the proposed transaction between the 1st Daughter and the 2nd Daughter turns sour.

The 2nd Daughter has nominated another CPA firm to be the single expert. An intimidation threat may be created if the 2nd Daughter insists on her choice. Even if the 2nd Daughter agrees to appoint ABC & Co., she may not fully co-operate during the valuation exercise, particularly as the 1st Daughter and the 2nd Daughter are likely to be multiple responsible parties providing information for the valuation.

(b) As possible safeguards, ABC & Co. should:

- involve an engagement partner on the valuation other than Mr. Au;
- involve a second partner review to ensure any contentious issues are well addressed;
- use separate teams for the valuation and the audit;
- confirm with the 1st Daughter and the 2nd Daughter regarding how the inputs, assumptions and calculations are reached in the valuation; and
- ensure that the 1st Daughter and the 2nd Daughter both acknowledge their responsibilities towards the supply of accurate and unbiased information for the valuation.

Answer 2

The specific controls which should be in place to ensure the proper functioning of CCC's proposed integrated computer system are as follows:

System design and supply

The design of the proposed integrated computer system should be secure, reliable, efficient, agile and cost-effective. Therefore, user involvement and management input are important during the system design and the selection of hardware supplies.

Also, consideration should be made regarding the system lifecycle and the possibility for future upgrades.

Training and implementation

Proper training on the system should be provided to front-line staff (for operation) as well as to management staff (for review and control) before implementation.

Implementation may be done in phases and/or in parallel with the existing system for an initial trial period.

Location of terminal devices

Terminal devices will be located throughout the five shops in Central, Admiralty, Causeway Bay, Tsim Sha Tsui and Tai Kok Tsui. Two of the shops are in shopping malls, whilst the rest are on main street at prime locations. As layouts and fittings are different, consistent and adequate control procedures, system infrastructures and technical support should be in place covering all the terminal devices regardless of their locations.

Access controls

Each of the terminal devices should be physically secured. Access controls should be exercised through a combination of user's identities, passwords and security keys. Users' identities should be unique to individual cashiers or operators. Passwords should be confidential subject to periodic prompted changes.

An automatic log-off function should be installed in case the screen is left idle for, say, two minutes.

Confidential data should be encrypted for transit. A firewall should be installed against hacking and intrusion.

Back-up files and contingency plans should be kept to avoid disruptions and to ensure data integrity.

Transaction trails

Transactions are recorded as they occur under the proposed real-time integrated system. It is possible that some visible transaction trails will be lost or will not be produced.

Some manual supporting records should be kept for such purposes. Alternatively, input data should be logged to provide the trails through the issue of printouts from the terminal on a daily basis.

Reporting and review

Audit logs, exception reports and other security monitoring reports should be prepared.

These reports should be reviewed by CCC's management for endorsement and/or appropriate actions.

Answer 3

(a) HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* requires ABC & Co. to gather, review and analyse the information through observation, inquiry and discussion to create a picture of CCC as a whole in order to understand the particular risks it faces.

Gift vouchers which are issued and sold to customers represent an obligation for CCC to provide the holders of those vouchers with goods and services equating to the face value of those vouchers. Therefore, it should form a liability in CCC's financial statements.

Comparing the print-runs and stacks of gift vouchers with the stock held in hand indicated that gift vouchers with a face value of HK$2.5 million were issued between January 20X7 and June 20X7. However, the sales records only showed that gift vouchers totalling HK$1.4 million were sold during the same period. Therefore, the completeness of CCC's liability and cash at bank is questionable. In particular, CCC's liability could have been understated by HK$1.1 million and the corresponding misstatement is likely to be an understatement of cash at bank of HK$1.1 million.

The discrepancy amounted to HK$1.1 million which is more than 5% of CCC's net profit (HK$19 million) according to its 20X7 management accounts. It is therefore likely to be material.

(b) ABC & Co. should understand and evaluate CCC's systems and internal control procedures relating to the issue, redemption, safekeeping and recording of the gift vouchers, such as:

- sequential pre-numbering controls and monitors of gift vouchers;
- validation and endorsement over the issue, cancellation and redemption of gift vouchers;
- physical safekeeping of gift vouchers;
- proper recording of the movements and balances of gift vouchers;
- reconciliation of gift vouchers; and
- review and approval of the reconciliation and exception reports.

(c) HKSA 200 (Clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing* requires ABC & Co. to:

- obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level; and
- plan and perform the audit with professional scepticism.

Professional scepticism does not mean that ABC & Co. should mistrust all information and representations provided by CCC and to take this approach would create a very difficult working relationship. However, a belief in the honesty and integrity of CCC's management does not relieve ABC & Co. of the need to maintain professional scepticism or allow ABC & Co. to be satisfied with less than persuasive audit evidence, i.e. an awareness of the nature and limitation of audit evidence is important.

By exercising professional scepticism, ABC & Co. should approach the audit with a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

Therefore, ABC & Co. should recognise the characteristics of gift vouchers which, in the context of auditing, may refer to their portability, convertibility and vulnerability to misappropriation.

ABC & Co. should be cautious regarding any suspicious and unusual circumstances which increase the risks of material misstatements and/or indicate the evidence of fraud.

Also, ABC & Co. should be aware when audit evidence contradicts other audit evidence obtained. For example, reviewing the reference numbers of the used gift vouchers (i.e. those redeemed by customers) should help to ascertain the causes of the discrepancies. If CCC can identify any particular customer who bought a large volume of gift vouchers (e.g. a bank using the gift vouchers as free gifts for its own customers), ABC & Co. may consider sending a confirmation to that customer.

ABC & Co. should avoid using unrealistic assumptions in designing audit procedures or evaluating audit evidence, e.g. sending negative confirmations to a large number of customers of CCC is not likely to produce any persuasive audit evidence.

ABC & Co. should consider the reasonableness of CCC's management responses to the discrepancy, i.e. whether or not and to what extent an investigation has been conducted; the findings of the investigation; the actions to contain and correct the discrepancy; and the measures to prevent the same problem from happening again.

Answer 4

ABC & Co. should consider if the food poisoning scandal (and forthcoming claim) would affect its assessment of the risk of material misstatements in respect of CCC's financial statements.

The scandal is an event which took place between the date of the financial statements and the date of the auditor's report. HKSA 560 (Clarified) *Subsequent Events* requires ABC & Co. to obtain sufficient appropriate audit evidence about whether this event is properly reflected in CCC's financial statements in accordance with the applicable financial reporting framework.

In view of the nature and scale of the event (which is likely to be a non-adjusting event under HKAS 10 *Events After the Reporting Period*), a disclosure should be made in CCC's financial statements. In particular, the disclosure should cover:

- the nature and details of the food poisoning event; and
- the nature, details and expected amount of the claim to be submitted by the victims.

Before concluding the audit opinion on CCC's financial statements for the year ended 31 December 20X7, CCC should:

- discuss with CCC's management the nature and details of the scandal;
- find out the assessment of the scandal by CCC's management;
- ask CCC's management if there are any significant subsequent events to their knowledge that should be brought to ABC & Co.'s attention;
- review CCC's management procedures for identifying subsequent events to ensure that the management is aware of the risks; and
- review CCC's internal documents up to the date of the auditor's report, such as:
  - meeting agendas, minutes and written resolutions of the board of directors and the management; and
  - correspondence with victims (claimants), lawyers, hospitals and expert doctors.

CASE STUDY 2 (June 2012)

Answer 1

(a) Existence and completeness due to certain significant controls over non-current asset registration were not properly implemented by the operation team.

Valuations due to certain significant control over non-current asset valuation were not properly implemented by the operation team.

(b) In response to the assessed risks of the non-current assets described in 1(a), ABC & Co. should consider whether the audit procedures are affected in terms of scope (e.g. additional procedures required) and extent (e.g. more sample sizes) in response to the risk identified.

Some audit procedures are suggested below:

Existence and completeness

- Understand the scope of the internal audit investigation report, e.g. location, business processes and controls.
- Understand from the internal audit and management the root cause of the control deficiencies identified and reassess the risk of material misstatement to non-current assets.
- Confirm that Super Energy physically inspects all items in the non-current asset register at year end.
- Inspect high value items from the non-current asset register at year end. Confirm the items inspected exist and are in good condition and have correct serial numbers.
- Confirm that Super Energy reconciles opening and closing assets by serial numbers as well as amounts.
- Obtain the non-current asset register with gross book value, accumulated depreciation and net book value, and reconcile with the opening position.
- Compare the non-current asset balance in the general ledger with the non-current assets register and obtain explanations for any differences.
- For a sample of non-current assets which physically exist, confirm that they are recorded in the non-current asset register.

Valuation

- Understand the scope of the internal audit investigation report, e.g. location of the exploration and production facilities that may have been potentially overstated or understated.
- Understand from internal audit and management the root cause of the control deficiencies identified and reassess the risk of material misstatement to non-current assets.
- Verify the valuation of the exploration and production facilities in the valuation report.
- Consider the source of valuation and review the valuation report, e.g. experience of valuer, scope of work, methods and assumptions used, and valuation bases are in line with accounting standards.

Answer 2

(a) In response to the accident, assessing the risk of material misstatements relating to Super Energy's financial statements as a whole, ABC & Co. should consider the following:

- The occurrence and completeness of the expenses incurred and paid relating to the accident.
- The adequacy of the provision for claim and litigation provided against the parties affected by the accident.
- The adequacy of the disclosure made in the financial statements in response to the accident e.g. provision and contingency made.
- The potential asset impairment loss after the accident.

[Note only three risks were required]

(b) ABC & Co. should consider the below audit procedures.

In response to the risk of material misstatement relating to the expenses incurred and paid:

- Understand and evaluate the controls in place for initiating and recording the expenses incurred and paid.
- Identify and validate the key controls relating to the expenses incurred and paid.
- Review the voucher register and expense ledger for large or unusual items.
- Check expenses recorded in the expense ledger or cash to supporting documents such as approved requisition forms to ensure the expenses are valid and are recorded in the correct expenses ledger.
- Test the arithmetical accuracy (i.e. by recalculating the amounts) on suppliers' invoices, voucher register and expense ledger.
- Perform procedures to search for unrecorded liabilities.

In response to the risk of material misstatement relating to the provision for claim and litigation:

- Make appropriate inquiries of management and others within Super Energy including in-house legal counsel.
- Review minutes of meetings of those charged with governance and correspondence with the entity's lawyers.
- Examine legal expenses accounts.
- Meet with Super Energy's external lawyers to seek their advice and request an opinion letter if necessary.
- Request management, or those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.
- Obtain details of all provisions for claim and litigation which have been included in the financial statements.
- Obtain a detailed analysis of all provisions for claim and litigation showing opening balances, movements and closing balances.
- Determine for each material provisions for claim and litigation whether Super Energy has a present obligation as a result of past events by reviewing the correspondence relating to the item and holding discussions with management.

- Compare the amount provided with the post year end payments and with any amount paid in the past for similar items.

In response to the adequacy of the disclosure made in the financial statement:

- Consider the adequacy of disclosure of provision for claim and litigation and contingent liabilities in the financial statements in accordance with HKAS *37 Provisions, Contingent Liabilities and Contingent Assets*.

In response to the potential asset impairment loss:

- Discuss with management the estimate of asset loss in the accident and understand their basis of the assessment.
- Verify the valuation of the asset in the valuation report.

Answer 3

ABC & Co. should consider the additional procedures below for risk assessment purposes:

- Review the Internal Audit Report in detail and discuss the internal audit findings with management and reassess the risk of material misstatements relating to the data integrity and reliability to the financial statements as a whole.
- Understand from management the remedial action plan and implementation time, e.g. use of CAAT to analyse and identify the inappropriate access, setting up a plan on rectifying the access control and segregation of duties with a detailed timeline.
- Identify whether there are compensating controls (e.g. monthly review of the exception log summarising the control access exceptions, understand and investigate the control access exceptions etc.).
- Consider performing testing of the compensating controls by understanding, evaluating and validating the key management compensating controls.

Answer 4

(a) The board of directors of Super Energy have direct corporate governance responsibility for the accident and should:

- Perform and present a balanced, clear and comprehensive assessment of the impact of the accident on Super Energy’s current year performance, statement of financial position and future prospects to both the shareholders and investors.
- Ensure maintenance of proper records for providing reliable financial, managerial and operating information for decision-making, evaluation of activities or publications relating to the accident.
- Ensure adequate control of the risks inherent in the rig operations, investigate the causes of the accident, act on the lessons learnt and improve the operation safety manual if necessary.
- Understand the impacts and implications of the accident and take appropriate actions to clean up the environment and provide appropriate compensation to those affected.
- Ensure Super Energy’s compliance with applicable legislation and regulations in terms of protecting employees' safety, protecting the natural environment and compensating those affected in the accident.
- Maintain an ongoing dialogue with shareholders and in particular, use the annual general meeting or other general meetings, to communicate with shareholders the development of the accident and the company’s responsive action, and encourage shareholders’ participation.

(b) The Audit Committee has the responsibility of liaising with ABC & Co., supervising internal audits and reviewing the annual financial statements and internal controls.

In response to the accident, the Audit Committee should:

- Discuss with the board of directors the setting up of an independent committee to investigate the causes of the accident.
- Set up and supervise an independent team to understand the root cause of the accident.
- Supervise the internal audit to review the operational procedures, identify control deficiencies and any improvement on operation procedures as required.
- Discuss with the board of directors and/or external advisors the procedures setting up for claims from those affected.
- Discuss with legal, finance and accounting departments/units and the internal audit the adequacy of provision and contingency made against the accident and the sufficiency of disclosures made in the quarterly and annual reports.

(c) ABC & Co. does not have direct corporate governance responsibility for the accident, but they are required to provide a check on the information aspects of corporate governance.

In response to the accident:

- ABC & Co. is required to give an opinion on whether the financial statements give a true and fair view, audit the validity of the expenses incurred, and assess the adequacy of provision and contingency made in response to the accident.
- ABC & Co. needs to have an understanding of the internal controls on expenses incurred, provision and contingency made in response to the accident, and should report any material deficiencies in internal control to the board and audit committee.
- ABC & Co. should communicate with the board or audit committee about significant risks that require disclosure in the financial statements, any uncertainties about the going concern assumption, any disagreements they have with management about the financial statements, and so on.
- ABC & Co. may be asked to check whether Super Energy follows the provisions in the Corporate Governance Code for the effectiveness of the system of internal control reviewed and reported on. This should cover all significant controls, including financial, operational and compliance controls and risk management systems.

CASE STUDY 3 (December 2011)

Answer 1

According to HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* the entity's risk assessment process refers to the internal process(es) of any entity for identifying the business risks which may affect financial reporting objectives; evaluating their significance; estimating their likelihood; and responding effectively to the issues identified.

Before entering into an acquisition, DREIT should carry out a full survey on the property to evaluate its condition and legal title. Any unauthorised or illegal building works and alterations should be identified for demolition or rectification.

As safety for those who use or occupy DREIT's real estate portfolio everyday should be set as the priority, such a message should be communicated to staff at all levels. Staff at all levels should be educated in order to raise their safety consciousness. Accordingly, DREIT should have a comprehensive set of health and safety as well as risk management procedures in place including regular reviews of the terms, scope and amounts of insurance coverage. In addition, consequential losses under various scenarios should be quantified and each of those impacts to DREIT should be evaluated as far as possible.

Answer 2

According to HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, fraud risk factors refer to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The fraud risk factors from the perspective of DREIT's auditor are as follows:

Inadequate safeguard of assets and ineffective monitoring of controls

The illegal extension of the commercial premises in New Territories indicates a lapse in safeguards and controls and/or an ineffective monitoring of risks and control failure.

Multi-location business

DREIT has a portfolio of 50 real estates comprising retail malls, commercial premises and car park facilities. Running a business in multiple locations increases the risks of having inconsistent (and possibly confusing) systems, controls and other procedures.

Excessive incentive linking to financial performance

As a substantial portion of the remuneration of DREIT's senior executives is closely linked to the growth rate of the distribution per unit, incentives to inflate the distributions can be excessively high.

Unusual increase of distribution per unit

DREIT's revenue and occupancy rate both increased by about 5%, while the net property income margin and average monthly unit rent per square foot remained constant. On the other hand, the distribution per unit increased by about 14%. Unless drastic cost reduction measures were implemented during the year, it is unclear what caused the growth in DREIT's distribution per unit.

Drastic cost reduction

Drastic cost reduction may decrease staff morale which can lead to a kind of rationalisation for fraudulent activities.

Questionable increases in distribution and gearing

DREIT's gearing increased from 18% to 20% despite the significant increase in distribution per unit. The combination of rapidly rising distribution and increasing gearing may represent a warning sign of some aggressive measures in boosting DREIT's financial performance.

[Note only four fraud risk factors were required]

Answer 3

(a) An effective audit committee can enhance the effectiveness, accountability, transparency and objectivity of the Manager's Board of Directors, and can also improve DREIT's corporate governance in the following ways:

External auditing

- Strengthen the position of DREIT's external auditor by providing an open channel of communication.

- Formulate a framework for DREIT's external auditor to maintain its independence when there are disputes with DREIT's management.

Financial reporting

- Improve the quality of financial reporting by reviewing the financial statements on behalf of DREIT's Board of Directors.
- Increase the involvement of the non-executive directors by assigning them to the audit committee to contribute independent viewpoints.
- Increase public confidence by raising the credibility and objectivity of DREIT's financial statements.

Internal control

- Strengthen the position of DREIT's internal auditor by separating it from executive management.
- Foster a culture of self-discipline, risk alertness and anti-fraud controls.
- Create a forum for DREIT's internal auditor in which they can raise issues of concern, and which they can use to get things done which might otherwise be difficult.

(b) The effectiveness of DREIT's audit committee may be gauged in the following ways:

The Manager's Board of Directors is equivalent to DREIT's governing body which should have a balanced composition of executives and non-executives (to maintain objectivity) drawing from a range of relevant expertise. As a subset of the Board, the audit committee should consist entirely of non-executive directors (at least three) particularly in the fields of accounting and finance. Also, some directors should have no financial interest in DREIT in order to maintain their independence.

Adequate resources should be set aside for the audit committee, so that an adequate number of members with the right calibre are appointed for access to management, external auditors and internal auditors.

DREIT's audit committee with proper terms of reference derives its authority from DREIT's Board of Directors under the requirements of the Listing Rules. Without proper authority, an audit committee would not be able to exercise the appropriate influence.

DREIT's audit committee should be diligent which refers to the extent to which audit committee members work together to fulfill the requirements, including background study of agenda items, preparation of questions, checking progress, understanding problems and dealing with DREIT's management, internal auditors, external auditors and other stakeholders.

Answer 4

(a) Under HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements*, Mr Kwok is required to form an opinion on DREIT's financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and to express clearly that opinion through a written report that also describes the basis for that opinion.

As DREIT is a unit trust established by the Trust Deed, authorised by the Securities and Futures Commission (SFC) under the Securities and Futures Ordinance (SFO) and regulated by the Code on Real Estate Investment Trusts (REIT Code), Mr Kwok should check their respective requirements to DREIT's financial statements, which effectively form the applicable financial reporting framework for DREIT.

HKSA 700 also states that an auditor may give an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Under HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report*, Mr Kwok may conclude that a modification to his opinion on DREIT's financial statements is necessary. There are three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The choice depends upon:

- the nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- the auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Mr Kwok should modify the opinion in the audit report when:

- he concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- he is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Under the circumstances of the case, Mr Kwok disagrees with DREIT's Manager as to whether a provision is necessary (ie a disagreement with management).

As Mr Kwok has also arrived at an estimate which is material, it is likely that Mr Kwok is not unable to obtain sufficient appropriate audit evidence to make a conclusion on the financial statements (ie not a limitation on the scope of the audit).

Therefore, Mr Kwok should express a qualified opinion, having obtained sufficient appropriate audit evidence, to conclude that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.

(b) Independent Auditor's Report to the Unitholders of Dummy Real Estate Investment Trust (DREIT)

(a collective investment scheme authorised under the Securities and Futures Ordinance)

Basis for Qualified Opinion

DREIT has a block of commercial premises in New Territories, part of which collapsed in December 20Y0. Evidence indicates that the collapse might have been caused by an unauthorised extension on the premises, and the losses might not be recoverable under the group insurance policy. The Manager has not set aside any provisions for the possible losses. If a provision is made, DREIT's net income and unitholders' equity would have been reduced by $xx.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of DREIT's affairs as at 31 December 20Y0, and of its net income and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the relevant provisions of the Trust Deed and the relevant disclosure requirements set out in Appendix C of the REIT Code.

Mr Kwok

Director

Mr Kwok's CPA incorporated practice

Auditor's address

Date of the auditor's report

Answer 5

In accordance with the Code of Ethics for Professional Accountants ("the *Code*") issued by the Hong Kong Institute of Certified Public Accountants, if Mr Kwok and his CPA practice, or a close/immediate family member, is offered gifts and hospitality from DREIT (ie a client), such an offer ordinarily gives rise to threats to compliance with the fundamental principles.

Self-interest threats to objectivity may be created if a gift from a client is accepted. Also, intimidation threats to objectivity may result from the possibility of such offers being made public.

The tenancy offered by DREIT appears to be significantly below the market rate in terms of the length of the initial rent-free period (ie 3 months in a 24-month tenancy) and the monthly rent per square foot (ie HK$10 comparing to DREIT's average monthly unit rent of HK$26).

Accordingly, this offer represents a gift and is not likely to be made in the normal course of business without any specific intent, and there is a significant threat to compliance with the *Code's* fundamental principles.

Therefore, Mr Kwok should reject DREIT's offer.

Also, Mr Kwok should consider DREIT's intention behind such offer (or gift) which might raise questions as to the management's integrity.

CASE STUDY 4 (June 2011)

Answer 1

B & Co is required to comply with the Code of Ethics for Professional Accountants ("the Code") issued by the HKICPA. Section 290 of the Code provides guidance on this matter.

Independence requires both independence of mind and independence in appearance.

There are two independence issues that Julie should be concerned about:

(i) Family and personal relationship

Julie is the audit manager-in-charge of ABC in which Thomas Chan, Julie's uncle, is ABC's new general manager and in charge of ABC's expansion plan and system implementation. There is a close personal relationship between Julie and Thomas. It may create a familiarity threat.

Familiarity threat occurs when due to a long or close relationship with an audit client, a professional accountant will be too sympathetic to their interests or too accepting of their work.

Being Julie's uncle, Thomas is senior to Julie. It may create intimidation threat when Thomas exerts significant influence through imposing pressure on Julie over the annual audit process especially on the system audit.

Intimidation threat occurs when a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

(ii) Provision for IT systems services to an assurance client

A self-review threat may be created if B & Co helps ABC on system design and implementation and later B & Co reviews the systems controls as part of its audit.

A self-review threat occurs when a firm or a professional accountant of the audit team could not appropriately evaluate the results of a previous judgement made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organisation, on which the accountant will rely when forming a judgment as part of providing a current service.

Julie should recommend to Ben that the safeguards include the following:

- Report to Ben her family relationship with Thomas and remove herself from the assurance team;
- Use different partners and engagement teams with separate reporting lines from the audit engagement teams to assist ABC on system design and implementation;
- Disclose to those charged with governance that B & Co is engaged by ABC on system design and implementation and the extent of the fees charged;
- Ensure there are policies put in place so that there is no exchange of confidential information between the assurance team and the non-assurance services team; and
- Consider not accepting the provision of system design and implementation services to ABC.

Answer 2

B & Co should assess the impact of the implementation of "SUCCESS" and plan the audit procedures during the risk assessment process.

B & Co should consider:

- whether the audit team possesses the required expertise in auditing SAP "SUCCESS";
- the timing of the audit procedures, eg performing pre-implementation review or post-implementation review; and
- the use of CAATs and other audit software in carrying out the journal entries testing.

B & Co. should test the general controls and application controls on transactions processed by "SUCCESS" for authorisation, completeness and accuracy.

In particular, B & Co. should plan the following audit procedures:

- Question the project manager and obtain an understanding of the computer controls, operating system, database system and implementation issues, if any;
- Understand, evaluate and validate the IT general controls, eg use of passwords, physical controls, controls over password, system development and maintenance controls, programming controls, transactions logs, firewalls, etc;
- Understand and walk through the end-to-end processes to confirm if there is any change of management procedures upon the system implementation;

- Evaluate and identify the key manual and IT application controls; and
- Validate the key manual and IT application controls, eg pre-processing authorisation, data validation test, input error reporting and handling, file controls, master file controls, balancing, etc.

In addition, B & Co. should also consider the audit procedures to ensure the data migrated from the old system to "SUCCESS" is complete and accurate. B & Co. should ensure that management's control is in place for data migration and perform relevant substantive testing, eg reconcile the July opening balances with the June closing balances.

Answer 3

(a) The risk of material misstatement relating to the completeness assertion of ABC's accounts payable as at 31 December 20Y0 is low to medium.

The last year audit results indicated no misstatement found on the accounts payable balance, even though the accounts payable confirmation replies of last year's audit did not agree with the suppliers' records but this could be reconciled and explained by ABC.

In addition, management has strengthened their internal controls over the completeness of accounts payable in the year by performing monthly reconciliations to suppliers' statements from overseas suppliers.

(b) B & Co should update their understanding of the purchase and payable processes of ABC, including relevant internal controls and accounting procedures, by inquiry, observation, examination and / or performing a walk-through test.

Then B & Co. should evaluate the design effectiveness of the controls and identify those key controls which can mitigate the risk of material misstatements to the financial statements.

Validate the operating effectiveness of the internal controls and accounting procedures over the purchase and payable processes during the year:

- Purchase orders are pre-numbered and approved by authorised persons;
- Goods received notes are pre-numbered and agreed with approved purchase orders;
- Matching of purchase orders, goods received notes and suppliers' invoices before trade payables are recorded;
- Segregation of duties;
- Management controls on monthly reconciliation to suppliers' statements from overseas suppliers; and
- Management cut-off procedures.

B & Co. should also consider some of the following substantive procedures:

- Send confirmation to local suppliers;
- Select a sample of suppliers' statements of local suppliers and trace to respective supplier's accounts;
- Perform purchase cut-off test on purchase from local suppliers;
- Examine files of unmatched purchase orders and supplier invoices;
- Search for unrecorded liabilities;
- Compare the balance to the relevant purchase and the previous months / year; and
- Compare the payables' turnover and payables' days to the previous year and industry data.

Answer 4

(a) The factors and procedures which should be considered in planning the year-end inventory count include the following:

(i) Ensure the audit coverage of the physical count is appropriate

- Confirm with management the nature and volume of the inventories in each of the three locations;
- Identify high value items; and
- Identify consignment inventories.

(ii) Review management's inventory count instructions

- Method of counting for inventory (eg full count vs cycle count);
- Restriction and control of the inventory movement during the count;
- Use of count tags and serial numbering, control and return of all count tags; and
- Recording of internal transfer.

(iii) Understand and evaluate the appropriateness of management's control over inventory count

- Segregation of duties (eg accounting department assisted in inventory count);
- Supervision by senior staff including senior staff not normally involved with inventory count (eg Thomas' direct supervision of the inventory count); and
- Reconciliation of inventory records and investigation and correction of any differences.

(iv) Because ABC's inventory count is not performed on 31 December 20Y0, roll-forward procedures from the date of the inventory count to year end date should also be planned.

(b) The risk of material misstatement relating to the completeness and accuracy assertion of ABC's inventories as at 31 December 20Y0 is medium.

Inaccurate date of migration may affect the completeness assertion of the year-end inventory balance. However, the year-end inventory count performed by management, investigation of differences and correction to inventory sub-ledger mitigates the risk of material misstatement on completeness assertion.

Miscommunication of user needs on inventory costing calculation to T&T on the design of IT controls in "SUCCESS" for calculating the inventory costing may increase the risk of material misstatement on accuracy assertion.

Significant decrease in inventory balance and improvement of gross profit percentage compared to prior year may be an indicator of an increase in risk of material misstatement on accuracy assertion.

(c) B & Co. should update their understanding of the inventory processes of ABC, including relevant internal controls and accounting procedures, by inquiry, observation, examination and/ or performing a walk-through test.

Then B & Co. should evaluate the design effectiveness of the controls and identify those key controls which can mitigate the risk of material misstatements to the financial statements.

Validate the operating effectiveness of the internal controls and accounting procedures over the inventory processes during the year:

- Inventory in and inventory out movements recording in “SUCCESS”;
- Year-end inventory count and variance investigation; and
- Application control of “SUCCESS” on inventory costing calculation.

In addition, B & Co.’s computer audit department needs to understand, evaluate and validate the data migration of inventory from old system to new system “SUCCESS”.

B & Co. should also consider some of the following substantive procedures:

- Perform physical inventory count on both 1 July 20Y0 and 31 December 20Y0;
- Trace test counts to the detailed inventory listing as at 31 December 20Y0; and
- Analytical procedures eg compare the group profit percentage with the previous year and industry data.

CASE STUDY 5 (December 2010)

Answer 1

(a) Under HKSQC 1 (Clarified) Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements, D&N should have policies and procedures in place for the acceptance of ADL’s audit nomination.

These policies and procedures are to give reasonable assurance that D&N will only undertake engagements where it:

- has considered the entity’s integrity and does not have information that would lead it to conclude that the entity lacks integrity (in this context, the entity refers to Mr. Chan, ADL’s management and ADL’s activities);
- is competent to perform ADL’s audit and has the capabilities, time and resources to do so; and
- can comply with ethical requirements.

Before accepting ADL’s nomination, D&N should obtain the above information and should document how any issues are resolved.

(b) Under the Code of Ethics for Professional Accountants (“the *Code*”) s.210 “Professional Appointment”, D&N should consider whether acceptance of ADL’s audit nomination would create any threats to compliance with the fundamental principles.

For example, the violation of intellectual property rights by ADL may threaten D&N's compliance with the fundamental principles, such as possible attempts to hide damages to the business through dishonesty and/or accounting irregularities.

Also, Mr Chan’s requests to D&N of charging the audit fee based on ADL’s profits may threaten D&N's compliance with the fundamental principles by creating a self-interest threat.

Under the *Code* s.440 “Changes in a Professional Appointment”, D&N should:

- find out whether the change of auditor has been properly dealt with in accordance with the Companies Ordinance or other legislation; and
- request ADL’s permission to communicate with the outgoing auditor.

If ADL has not properly dealt with the change of auditor, D&N should decline the nomination.

Answer 2

(a) The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

(b) Nancy's assessment was formed based on HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* which requires an understanding of ADL and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

In addition, HKSA 315 (Revised) requires Nancy to identify and assess the risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures. In general, D&N is not required to give any particular response for a low risk assessment in the risk of material misstatement at the financial statement level, other than maintaining a professional scepticism in gathering and evaluating audit evidence.

HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that:

Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Accordingly, even if Nancy assessed the risk of material misstatement at the financial statement level due to fraud as low, D&N should perform audit procedures in responding to the (presumed) risk of management override of controls.

The relevant audit procedures in response to Nancy's assessment are to:

- test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;
- review accounting estimates for biases that could result in material misstatement due to fraud; and
- obtain an understanding of the business rationale of significant transactions that D&N becomes aware of that are outside of ADL's normal course of business or that otherwise appear to be unusual.

Answer 3

(a) Under HKSA 570 (Clarified) *Going Concern*, Nancy should consider the appropriateness of ADL's use of the going concern assumption in the preparation of the financial statements when planning and performing audit procedures and in evaluating the results thereof.

Under the going concern assumption, ADL is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.

Accordingly, ADL is expect to realise its assets and discharge its liabilities in the normal course of business.

(b) Examples of events or conditions, which may invalidate the going concern assumption in ADL's financial statements, are as follows:

(i) Mr Chan's intention to retire in the next two to three years

As the founder and executive management of ADL, Mr Chan's expertise and technical know-how may be lost irretrievably as and when he retires from ADL.

Such expertise and technical know-how may be critical to ADL's operation.

(ii) Further burden on the liquidity risk from the compensation on the lawsuit

Although HK$30 million out of the total compensation of HK$50 million has been provided in the accounts, none of the compensation (provided or not provided) has been paid.

It is not certain if ADL has enough cash (or liquid assets) to make the payment.

(iii) Deterioration of financial performance causing difficulties to attract new business partners or investors which may threaten the continuation of ADL

ADL's gross profit margin has declined from 32.46 per cent (y/e 31 March X9) to 29.13 per cent (9 m/e 31 December X9).

ADL's net profit margin has declined from 11.12 per cent (y/e 31 March X9) to 10.20 per cent (9 m/e 31 December X9).

(iv) Depressed financial position hindering inflows of new funds or re-capitalisation which may otherwise threaten the funding of ADL's daily operations

ADL's current ratio has remained below one at 0.99 (on 31 March X9 and 31 December X9).

Although ADL's net assets have improved from HK$83,626,000 (at 31 March X9) to HK$94,230,000 (at 31 December X9), it will be reduced to HK$74,230,000 after the payment of HK$50 million.

(v) Damages to ADL's name and reputation due to the violation of intellectual property rights

ADL's violation of intellectual property rights is adverse publicity hitting its name and reputation.

Some existing customers of ADL may turn away from buying its products due to the perception that ADL is dishonest and irresponsible.

Answer 4

(a) Under HKSA 560 (Clarified) *Subsequent Events*, subsequent events are:

- events occurring between the date of financial statements and the date of the auditor's report; and
- facts that become known to the auditor after the date of the auditor's report.

(b) The audit procedures of Nancy and her engagement team in respect of subsequent events should cover the period from the date of financial statements (ie 31 March 20Y0) to the date of the auditor's report.

These audit procedures should be performed as near as practicable to the date of the auditor's report.

Examples of these audit procedures are as follows:

(i) Review the procedures that ADL's management has established to identify subsequent events.

(ii) Read the minutes of shareholders' and directors' meetings held after 31 March 20Y0 and inquire about matters discussed at meetings for which minutes are not yet available.

(iii) Read ADL's latest available management accounts and other related management reports (eg budgets and cash flow forecasts).

(iv) Inquire of ADL's lawyers concerning litigations and claims, particularly in connection with the violation of intellectual property rights lawsuit.

(v) Inquire of ADL's management as to whether any subsequent events have occurred which might affect the financial statements.

In particular, Nancy and her engagement team should ask about:

- the current status of the lawsuit;
- whether sales of assets or businesses have occurred or are planned (due to Mr Chan's intention to retire);
- whether the issue of new shares or debentures has been made or is planned;
- whether an agreement to merge or liquidate has been made or is planned; and
- whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, particularly in connection with the validity of the going concern assumption.

CASE STUDY 6 (February 2010)

Answer 1

ABC & Co. ("ABC") is required to comply with the *Code of Ethics for Professional Accountants* ("the *Code*") issued by the HKICPA.

Using the same senior personnel on an assurance engagement over a prolonged period may create a familiarity threat.

Familiarity threat occurs when due to a long or close relationship with an assurance client, a professional accountant will be too sympathetic to their interests.

In this case, Simon has been the lead engagement partner for the audit of HKB for the past seven years and this long association with HKB may have caused Simon to become too sympathetic to HKB's interests, thus creating a familiarity threat.

ABC should apply the following safeguards to eliminate or reduce the familiarity threat to an acceptable level:

1 For a listed company, the lead engagement partner should be rotated after a pre-defined period (normally no more than seven years), and should not resume the lead engagement partner role until a further period of time (normally two years) has elapsed.

As HKB is a listed company and Simon has been HKB's lead engagement partner for the past seven years, Simon should be rotated off HKB's 20Y0 audit and should not reassume the role of HKB's lead engagement partner until the 20Y2 audit.

2 If it is not feasible to rotate Simon, ABC should involve an additional professional accountant who is not a member of the assurance team to review the work done by Simon or otherwise advise as necessary.

3 For a listed company, the partner-in-charge of the engagement quality control review should be rotated after a pre-defined period (normally no more than seven years), and should not resume the partner-in-charge of the engagement quality control review role until a further period of time (normally two years) has elapsed.

As HKB is a listed company and Tony has been the partner-in-charge of the engagement quality control review for the HKB for the past seven years, Tony should be rotated off HKB's 20Y0 audit and should not reassume the role of HKB's partner-in-charge of the engagement quality control review until the 20Y2 audit.

Answer 2

(a) Risks of material misstatement at the financial statement level relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The following facts indicate a low risk of material misstatement at the financial statement level:

1 HKB has good corporate governance.

(a) HKB complies with all the Code Provisions contained in the Listing Rules, including separating the roles of Chairman (Mr. Raymond Lee) and Chief Executive Officer (Mr. Samuel Ho).

(b) HKB commits to maintaining the highest standards of corporate governance.
The cornerstones of HKB's corporate governance practices are accountability, transparency, and integrity.

(c) HKB aims to be a responsible business that cares about corporate social responsibility. For example, HKB makes great efforts in its normal business conducts to save resources through energy conservation and waste management.

2 HKB has a good control environment that is based on good business ethics and accountability:

(a) HKB has in place a formal Code of Ethics which is communicated to all staff (including new recruits).

(b) HKB's "whistle-blowing" system is monitored by an independent third party service provider with direct reporting to the Chairman of the Audit Committee.

(c) HKB aims to build risk awareness and control responsibility into its culture and regards this as the foundation of its internal controls system.

3 Worsened economic conditions in Hong Kong might not have created undue pressure on HKB's management:

(a) HKB has a well-balanced portfolio of superior investment properties. HKB has a quality client base and does not unduly depend on any particular type of tenant.

(b) HKB maintains sustainable income with high occupancy consistently achieved (close to 100% even for the year ended 31 March 20Y0) and the average lease term is much longer than its competitors.

(c) HKB has been adopting prudent financial policies such as making advance arrangements for debts to be re-financed in 20Y1.

4 Last but not the least, HKB has a good financial position. In comparing with 20X9:

(a) revenue for 20Y0 has increased by 19.5%;

(b) gross profit margin (property expenses as a percentage of turnover) has been maintained at a relatively high (low) level;

(c) debt to equity (or debt to total assets) ratio has been maintained at a relatively low level;

(d) interest coverage has increased from 6.6 times to 9.36 times; and

(e) current ratio has increased from 0.92 to 1.44.

Performance indicators	20Y0	20X9
Revenue growth	19.5%	n/a
Gross profit margin	86.75%	84.7%
Property expenses as a percentage of revenue	13.25%	15.3%
Debt to equity	23.6%	21.3%
Debt to total assets	19.1%	17.6%
Interest coverage (times)	9.36x	6.60x
Current ratio (times)	1.44x	0.92x

(b) After initial recognition, an entity that chooses the fair value model, such as HKB in this case, shall measure all of its investment properties in accordance with the requirements of HKAS 40 *Investment Property* for that model.

Under the fair value model, the overall audit objective of ABC in examining the valuation and allocation assertion of investment property is to satisfy that items of investment property are stated at an appropriate amount and any resulting valuation adjustments are appropriately recorded.

The measurement of fair value may be relatively simple for certain assets or liabilities that are bought and sold in active and open markets. In other situations, such as the case of investment properties, management of HKB normally has to rely on the expert (professional valuer) to estimate the fair values.

HKSA 620 (Clarified) *Using the work of an auditor's expert* requires ABC to assess the professional competence and objectivity of the expert when planning to use the work of an expert. In this case, ABC should ensure that the professional valuer is an independent valuer who holds a recognised and relevant professional qualification (eg, a member of the Royal Institute of Chartered Surveyors ("RICS")) and has recent experience in the valuation of similar properties in Hong Kong.

HKSA 620 (Clarified) also requires ABC to assess the scope and appropriateness of the professional valuer's work as audit evidence based on:

- ABC's understanding of the methods and significant assumptions used by the expert in determining the fair value of investment properties, and
- ABC's consideration as to whether these assumptions and methods are appropriate, complete and reasonable.

Audit procedures to verify the carrying amount of the investment property as at 31 March 20Y0 may include the following:

- Examine the accounting policies for investment property. Determine whether the carrying amount of investment property at the period end comply with HKB's accounting policies and HKAS 40.
- Obtain a reconciliation between the carrying amounts of the investment property between 1 April 20X9 and 31 March 20Y0, showing items such as additions, disposals and transfer of investment properties, and net change in fair value.
- Agree the balance of investment property as at 1 April 20X9 to last year's audited accounts.
- Review or re-perform the calculations of carrying amount as at 31 March 20Y0, including the examination of the supporting documents for:

  (i) additions of investment properties resulting from acquisitions and from subsequent expenditure recognised after initial recognition during the period;

  (ii) disposals of investment properties by sale or by entering into finance lease during the period;

  (iii) derecognition of investment properties;

(iv) transfers of investment properties to and from inventories, owner-occupied property, and property, plant and equipment during the period;

(v) net gains or losses arising from changes in the fair value of investment properties during the period; and

(vi) other movements involving net exchange difference and other changes as per HKAS 40.

Answer 3

Jimmy, as a professional accountant in public practice, is required to comply with the Code of Ethics for Professional Accountants ("the *Code*") issued by the HKICPA.

Self-interest threat is the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behaviour.

In this case, a self-interest threat would be created because a direct financial interest in an audit client (one million shares of HKB's ordinary shares) is involuntarily received by Jimmy (an audit team member of the HKB audit) by way of an inheritance due to the sudden death of his rich uncle.

ABC should apply the following safeguards to eliminate the self-interest threat to an acceptable level:

(a) ABC requests Jimmy to dispose of the inherited HKB shares at the earliest practical date; or

(b) ABC removes Jimmy from the HKB audit engagement.

During the period prior to disposal of the HKB shares or the removal of the Jimmy from the assurance team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level.

Such safeguards might include:

(a) discussing the matter with those charged with governance, such as HKB's audit committee; or

(b) involving an additional professional accountant to review the work done by Jimmy, or otherwise advise as necessary.

An inadvertent violation of Section 290 as it relates to a financial interest in an audit client (HKB in this case) would not impair ABC's independence if all of the following conditions are met:

(a) ABC has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance (Jimmy's inheritance in this case) or other acquisition of a financial interest in the audit client;

(b) ABC promptly notify the professional (Jimmy) that the financial interest (HKB's shares) should be disposed of; and

(c) the disposal occurs at the earliest practical date after identification of the issue, or the professional (Jimmy) is removed from the assurance team.

Answer 4

(a) As part of the substantive procedures, Susan should take the following audit steps in tests of details:

- Obtain bank reconciliation from the client.
- Check the casting of reconciliation and cash/bank books.
- Agree two balances per reconciliation to bank statement (and bank confirmation) and cash/bank book respectively.
- Check outstanding cheques to the cash/bank book to ascertain that they were issued before the year end as well as to the bank statement of subsequent periods to ascertain that they have been cleared promptly after the year end.
- Check outstanding cash deposits are actually placed to bank before year end and recorded in cash/bank book before the year end but only recorded in the bank statement after the year end.
- Appropriate adjusting journal entries were made by the client for non-sufficient fund cheques and other items charged/credited by the bank such as interest expense/income, bank charges and auto-pay items.
- Ensure all material entries on bank statements (but not in cash/bank book) are properly dealt with through adjustments.

(b) The two mistakes are as follows:

	Possible mistakes	Impacts	Recommendations
1	Not sending bank confirmation requests to those banks of which the accounts were closed during the year seems to be a non-compliance with HKSA 505 (Clarified) *External Confirmations* (Appendix 1).	There may be other banking relationships with those banks of which the accounts were closed during the year. There are risks of undisclosed liabilities, commitments, guarantees and/or assets.	HKSA 505 (Clarified) requires that the auditor should send bank confirmation requests when the entity's banking activities are significant to the audit. Therefore, Susan should send bank confirmation requests to all relevant banks even for those of which the accounts were closed during the year.
2	Agreeing the balances to bank statements is not ordinarily accepted as an alternative to confirming with bank directly.	Other than the verification of the actual balances, the banks would reveal information about loans, mortgages, guarantees and/or collaterals.	If the bank does not respond to a confirmation request, Susan should send a second request and should ask HKB to follow up with the bank.

CASE STUDY 7 (May 2009)

Answer 1

(a) Before accepting the audit engagement, the engagement team/partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented.
In general, such procedures include considering:

(i) the integrity of HKM and whether there is any information that would lead the engagement team to conclude that HKM lacks integrity;

(ii) whether the engagement team is competent to perform the audit engagement and has the necessary time and resources; and

(iii) whether XYZ & Co and the engagement team can comply with other ethical requirements, such as independence.

(b) During the engagement performance, the engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances.

The engagement partner should review the audit documentation and discuss it with the engagement team to satisfy himself/herself that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

The engagement partner should also satisfy himself/herself that members of the engagement team have undertaken appropriate consultations for any difficult or contentious issues arising during the course of the engagement.

If differences of opinion arise (which may be within the engagement team, between the engagement team and those consulted, or between the engagement partner and the engagement quality control reviewer) the engagement team should follow the firm's policies and procedures for dealing with and resolving differences of opinion.

(c) Since HKM is a listed company, the engagement partner should ensure that an appropriate engagement quality control reviewer has been appointed.

The engagement partner should discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

XYZ & Co should not issue the auditor's report until the completion of the engagement quality control review.

Answer 2

(a) An increase in audit materiality increases the total error that the auditor is willing to accept.

Therefore, at a given level of assessed risk, an increase in the audit materiality level in the revenue of HKM will reduce the sample size for the tests of details.

At a given level of audit materiality, a reduction in the auditor's assessment of the risk of material misstatement will reduce the sample size.

Provided that the engagement team is satisfied that assessed risks of the relevant assertions of revenue were low, for example by performing appropriate tests of controls to obtain evidence of the operating effectiveness of the controls during the period, the extent of tests of details, ie the sample size, could be kept to a minimum.

(b) Occurrence of the sales transactions refers to the assertion that all sale transactions recognised by HKM during the year represent transactions that had actually occurred and pertained to HKM.

The fact that documents are missing indicates that there may be weaknesses in HKM's internal controls, particularly if these were not identified by HKM's own system but by the engagement team.

This, however, does not necessarily indicate that the transaction had not occurred or did not pertain to HKM.

The engagement team should perform other audit procedures to verify the occurrence of this particular transaction, for example, by inspection of any documentary evidence of inventory movements for the transactions and subsequent settlement of the receivables arising.

Where necessary, the engagement team may ask the customer to confirm this particular sale transaction.

Unless the engagement team fails to obtain evidence of the occurrence of the transactions by these means, the sample item should not be classified as an error for the purpose of the tests of details.

The engagement team should however reconsider whether the assessed risks of material misstatement remain valid in view of the fact that HKM's internal controls have failed to locate the missing documents.

If the engagement team perform tests of details concurrently with tests of control, the engagement team may need to increase the extent of tests of control to obtain evidence that the assessed risk of material misstatement can be maintained as low.

If the engagement team fails to satisfy themselves that the assessed low risk of material misstatement can be maintained, the engagement team should revise the nature and timing of tests of details.

Answer 3

(a) In accordance with HKSA 610 (Revised 2013), when intending to use the work of HKM's internal auditors, the engagement team should evaluate its adequacy for the external audit's purposes by considering whether:

(i) The work is performed by persons having adequate technical training and proficiency as internal auditors, and the work of assistants is properly supervised, reviewed and documented;

(ii) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;

(iii) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and

(iv) Any exceptions or unusual matters disclosed by internal auditing are properly resolved.

(b) Physical inspection of property, plant and equipment ("PPE") provides evidence of the existence (but not ownership or value) of the PPE.

With respect to the year-end physical inspection of PPE, it would be time-consuming and costly for the engagement team to inspect all PPE. Consequently, PPE is a key area in which the engagement team would like to rely on the work of HKM's internal auditors.

This would require the engagement team to review and appraise the internal audit work programme prior to the physical inspection of PPE and review their work afterwards. Some reperformance of internal audit procedures would be required.

The engagement team would still need to inspect all material PPE items.

[Marks will be awarded for other valid points.]

Key internal controls for the completeness of merchandise acquisition from suppliers are likely to include pre-numbering and accounting for the sequence of purchase orders, goods received notes and vouchers.

The work of HKM's internal auditors is likely to relate to performing regular sequence checks on a sequence of the pre-numbered purchase orders, goods received notes and vouchers.

Since it is likely that a large number of acquisition transactions will be involved, this internal auditors' work will be of interest to the external auditors. The engagement team will rely on the work of HKM's internal auditors.

Before relying on HKM's internal auditors, the engagement team will review and appraise the internal audit work programme for the sequence check of purchase orders, goods received notes and vouchers, and review their work afterwards. Some reperformance of tests performed will also be required.

[Marks will be awarded for other valid points.]

Answer 4

The provision for losses from a lawsuit is a kind of accounting estimate. In accordance with HKSA 540 (Clarified) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, XYZ & Co should adopt one or a combination of the following approaches in the audit of the HK$4,305,200 provision:

(a) Review subsequent events which provide audit evidence of the reasonableness of the estimate made;

(b) Review and test the process used by HKM's management to develop the estimate;

(c) Test the controls over how management made the estimate, together with appropriate substantive procedures; or

(d) Use an independent estimate for comparison with that prepared by HKM's management.

Testing the controls over how the estimate was made

XYZ and Co should test the operating effectiveness of the controls operating over how HKM's management made their estimate of the provision required.

Reviewing and testing the process used by management

The amount of provision is not a rounded figure suggesting that the management has adopted a detailed process in deriving the estimate.

XYZ & Co should evaluate the data and assumptions on which the estimate is based for reasonableness and sensitivity, such as:

- recent court cases;
- life expectancy of the injured;
- expected inflation rates;
- expected interest rates; and
- expected employment prospects.

If applicable, XYZ & Co would seek direct communication with HKM's lawyers.

XYZ & Co should also test the calculations of this provision. The nature, timing and extent of the tests will depend on the assessed risk of material misstatement, the complexity of calculation, XYZ & Co's understanding and evaluation of the procedures and methods used by HKM, and the materiality of the estimate.

XYZ & Co should consider the procedures for management's approval of the provision for reasonableness. XYZ & Co would consider whether review and approval are performed by the appropriate level of management and that this is evidenced in the documentation supporting the determination of the accounting estimate.

Review of subsequent events

Transactions and events which occur after year end, but prior to completion of the audit, may provide audit evidence regarding the provision made by HKM's management.

It is usual to negotiate a settlement before legal proceedings or trial. If a settlement is reached after the year end, XYZ & Co may not need to review and perform any audit procedures other than comparing the terms of settlement to the provision.

Use of an independent estimate

XYZ & Co may make or obtain an independent estimate for the quantum of potential losses (such as independent legal or forensic advice in assessing the strength of the case and the quantum of compensation) and compare it with the provision prepared by HKM's management.

It may also be appropriate to compare provisions and other accounting estimates made for prior periods with the history of compensation payments and the actual results of those periods.

CASE STUDY 8 (September 2008)

Answer 1

(a) Gold and Silver should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements in accordance with HKSQC 1 (Clarified) *Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.*

Gold and Silver should also ensure that appropriate procedures regarding the acceptance of the new client relationships are being followed and that conclusions are appropriate and documented, in accordance with HKSA 220 (Clarified) *Quality control for an Audit of Financial Statements*.

Under the circumstances of the question, Ms Or (and/or Gold and Silver) should consider the following matters:

- The integrity of Ms Au;
- The integrity of other principal shareholders, key management and those charged with governance (and the extent of influences by Ms Au on them);
- Whether the engagement team is competent to perform the audit engagement of business in decorative lightings industry;
- Whether the engagement team has the necessary time and resources (in particular, Gold and Silver is short of manpower); and
- Whether Gold and Silver and the engagement team can comply with ethical requirements.

The engagement team should obtain such information as it considers necessary in the circumstances before accepting an engagement by ZZZ as a new client. Where issues have been identified and Gold and Silver has decided to accept the client relationship with ZZZ (in particular, the audit of its financial statements for the year ended 31 December 20X8), Gold and Silver should document how the issues are resolved.

(b) Ms Or should consider the business reputation of Ms Au, the key management, related parties and those charged with ZZZ's governance. The question has no information indicating that Ms Au or the management of ZZZ is ignorant of the principles of corporate governance or the duties of directors.

Ms Or should consider the nature of ZZZ's operations, eg whether or not ZZZ has been engaged in speculative activities and/or accepting unusually high business risks. Accepting unusually high business risks may suggest that the management is not acting in the best interests of ZZZ.

Ms Or should consider whether or not ZZZ has been engaging in complex transactions or aggressive deals that make the determination of the effects on the financial statements unnecessarily highly subjective. Unless it is a business norm, unnecessarily complex transactions or aggressive deals may suggest that the management is not acting in the best interests of ZZZ.

Ms Or should assess Ms Au's attitude towards matters such as aggressive interpretation of accounting standards and/or the internal control environment, such as whether or not Ms Au has exercised her power to override internal controls unnecessarily.

Ms Or should find out whether or not the reasons for the non-appointment of Red and Blue related to the integrity of ZZZ.

Ms Or should check whether or not Ms Au displays a positive attitude towards compliance with regulatory or contractual obligations.

Ms Or should check for any indication of money laundering and/or other criminal activities by Ms Au (or ZZZ).

(c) Under the *Code of Ethics for Professional Accountants* ("the *Code*") section 440 "Changes in a Professional Appointment", Gold and Silver should find out whether the change of auditor has been properly dealt with in accordance with the Companies Ordinance or other legislations/regulations.

If the change of auditor has not been properly dealt with, Gold and Silver should not accept the invitation.

Gold and Silver should also request ZZZ's permission to communicate with Red and Blue.

Gold and Silver should not accept the invitation without first communicating in writing with Red and Blue to inquire whether there is any reason for or circumstance behind the proposed change of which they should be aware when deciding whether or not to accept nomination.

Section 440 of the Code requires Gold and Silver, with ZZZ's permission, to write to Red and Blue asking if there are any unusual circumstances surrounding the proposed change which Gold and Silver should be aware of, so that Gold and Silver may determine whether or not to accept the nomination.

Since ZZZ is a listed company, the change in auditor is also governed by Section 441 of the *Code* "Change of Auditors of a Listed Issuer of The Stock Exchange of Hong Kong".

In accordance with section 441 of the Code, Gold and Silver should request a copy of the letter of resignation and any correspondence referred to in the letter directly from ZZZ for consideration in addition to the professional clearance from Red and Blue before accepting the appointment.

If ZZZ refuses to provide Gold and Silver with a copy of the letter of resignation and any correspondence referred to in the letter of resignation, Gold and Silver should decline the appointment.

Answer 2

(a) The existence assertion of inventories refers to whether or not the carrying amount of inventories on ZZZ's statement of financial position exists as at 31 December 20X8.

The risk of misstatement of the existence of ZZZ's inventory balance as at 31 December 20X8 appears medium to high because of the following:

- ZZZ's inventories consist of various types of lighting products with different carrying amounts, and their appearance may not be readily distinguishable to laypersons so as to establish their makes or types (unless the stocktaking team is made up of lighting experts).
- Many components of lighting products are highly desirable and movable, ie the susceptibility of assets to loss or misappropriation is high.
- Many components of lighting products are vulnerable to theft, and fraudulent schemes may be used to disguise the unaccounted portion of inventories.
- ZZZ's inventories are kept in four factories in mainland China, and there may be goods in transit during the inventory counting. Therefore, there are risks of duplication or omission.
- It can be difficult to determine the existence of work-in-progress (ie stage of completion).

(b) ZZZ's inventories at 31 December 20X8 are likely to be material because the carrying amount as at 31 August 20X8 (HK$340,501,000) represents approximately:

- 472.9% of net profit for the eight months ended 31 August 20X8
- 477.1% of net profit for 20X7
- 37.8% of current assets at 31 August 20X8
- 43.0% of net assets at 31 August 20X8
- 21.4% of total assets at 31 August 20X8

As the inventory is material and in accordance with HKSA 501 (Clarified) *Audit Evidence: Specific Considerations for Selected Items*, Gold and Silver should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at the physical stocktaking.

During attendance at ZZZ's physical stocktake, Gold and Silver should review the stocktake instructions from ZZZ, observe the counting procedures and perform test counts.

Gold and Silver should assess the independence and competence of ZZZ's counting team and whether the team is appropriately briefed and supervised.

When performing the test counts, Gold and Silver should trace items selected from the records to the physical inventory for overstatement (existence). Gold and Silver should also trace items selected from the physical inventory to the count records for understatement (completeness).

Gold and Silver should perform cut-off procedures on the details of the movement of inventory just prior to, during and after the count.

Gold and Silver should consider the needs to obtain expert confirmation about the nature and specification of some lighting products (due to the wide range and varieties of models and specifications).

As there are four locations in mainland China, Gold and Silver needs to consider at which locations attendance is appropriate, taking into account the materiality of inventory and the risk of material misstatement at different locations.

For practical reasons, the physical inventory count may be conducted at a date other than period end. Gold and Silver would determine whether, through the performance of appropriate audit procedures, changes in inventory between the count date and the period end are correctly recorded.

When inventory is under the custody and control of a third party, Gold and Silver should obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity or perform a physical count directly in the third party's custody if the risk is high.

Gold and Silver should consider the procedures of recording the stocktake results onto the financial statements.

(c) The carrying amount of ZZZ's inventories at 31 December 20X7 is regarded as the “opening balance” of inventories in the upcoming audit of financial statements for 20X8.

Opening balances are based on the closing balances of the prior period, ie balances at 31 December 20X7, and reflect the effects of (1) transactions of prior periods; and (2) accounting policies applied in the prior periods.

A material misstatement in the opening balance of ZZZ's inventories (if not properly restated) could have a consequential effect on the profit or loss for 20X8. Any misstatements in the inventories at 31 December 20X7 could materially affect the financial statements for 20X8.

In accordance with HKSA 510 (Clarified) *Initial Audit Engagements – Opening Balances*, Ms Or (Gold and Silver) should obtain sufficient appropriate evidence that:

- The opening balances do not contain misstatements that materially affect ZZZ's financial statements for 20X8;
- The prior year's closing balances have been correctly brought forward to 20X8 or, when appropriate, have been restated; and
- Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed.

As an initial audit engagement it would be impossible, so Gold and Silver is not required to perform a physical count on the beginning balance of inventories. According to the paragraph A4 of HKSA 510 (Clarified) *Initial Audit Engagements – Opening Balances*, when the prior period's financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by reviewing the predecessor auditor's working papers. In these circumstances, the current auditor would also consider the professional competence and independence of the predecessor auditor.

Answer 3

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, according to HKAS 36 *Impairment of Assets*. The recoverable amount of receivables is the present value of estimated future cash flow, discounted at the effective interest rate.

As some of ZZZ's customers may not settle their debts fully, Ms Or may explain to Ms Au that the recoverable amount of ZZZ's accounts receivable can be lower than the carrying amount (which presumably is the invoiced amount) totalling HK$ 287,094,000 at 31 August 20X8 (HK$197,290,000 at 31 December 20X7). Accordingly, impairment of receivables reflects an allowance to reduce accounts receivable to their recoverable amount.

Ms Or may explain to Ms Au that impairment of receivables is a kind of accounting estimate in the absence of a precise means of measurement, and that there are at least three bases in calculating the impairment of receivables:

- As a consistent proportion of total receivables;
- As a consistent proportion of sales; and
- As a progressive proportion according to the ageing of respective receivable balances.

In addition, it is often the case that the management would assess the impairment of receivables on individual basis.

Based on the reported figures on the financial statements and management accounts, Ms Or may explain to Ms Au that, at 31 August 20X8, the impairment of receivables of ZZZ stays at the same level as 31 December 20X7 at HK$2 million, indicating a sign of inadequacy in the context of the relevant financials as follows:

- 0.70% of receivables at 31 August 20X8 (1% at 31 December 20X7)
- 0.29% of sales for January 20X8 to August 20X8 (0.25% of total sales for 20X7)
- 0.19% of projected total sales (HK$ 1,050,688,500) for 20X8

Ms Or may draw Ms Au's attention to the age profiles of the accounts receivable which have become more slow moving from December 20X7 to August 20X8. This suggests that the "quality" of the accounts receivable appear to have declined. In addition, ZZZ's revenue has increased significantly during 20X8.

Furthermore, based on the monthly analysis of ZZZ's sales, the receivables turnover days has increased to three+ months for the period from January 20X8 to August 20X8, while the receivables turnover for 20X7 was almost exactly three months. This indicates that on average ZZZ's customers have taken a longer period of time to settle their debts. ZZZ may face the risk of overtrading resulting in undue pressure on its cash and working capital.

Ms Au and the management of ZZZ are responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainties regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment. Impairment of receivables may be determined as part of the routine information system relevant to financial reporting operating on a continuing basis, or as a non-routine function operating only at the year end.

Answer 4

(a) As per HKSRE 2410, the objective of a review of interim financial report is to enable the auditor to express a conclusion whether anything has come to his attention that causes him to believe that the interim financial report is not prepared, in all material respects, in accordance with HKAS 34 *Interim Financial Reporting*.

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial report is free from material misstatement. A review provides limited assurance.

A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review may bring significant matters affecting the interim financial report to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

(b) Gold and Silver should perform the review of ZZZ's interim financial report in accordance with HKSRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.

With respect to the other information that accompanies the interim financial report of ZZZ, Gold and Silver should read it to consider whether any such information is materially inconsistent with the interim financial report.

If Gold and Silver identifies a material inconsistency, Gold and Silver should consider whether the interim financial report or the other information needs to be amended.

If Gold and Silver believes that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with HKAS 34, and management of ZZZ refuses to make the amendment, Gold and Silver should express a qualified conclusion when the effect of the amendment is material but not pervasive or an adverse conclusion when the effect of the amendment is material or pervasive.

If an amendment is necessary in the other information and management of ZZZ refuses to make the amendment, Gold and Silver should consider including in the review report an additional paragraph describing the material inconsistency, or taking other actions, such as withholding the issuance of the review report or withdrawing from the engagement.

If the other information of ZZZ appears to include a material misstatement of fact, Gold and Silver should discuss the matter with ZZZ's management to determine whether valid differences of judgment or opinion exist and whether to request ZZZ's management to consult with a qualified third party to resolve the apparent misstatement of fact.

If an amendment is necessary to correct a material misstatement of fact and ZZZ's management refuses to make the amendment, Gold and Silver should consider taking further action as appropriate, such as notifying the audit committee of ZZZ and obtaining legal advice.

CASE STUDY 9 (February 2008)

Answer 1

(a) The engagement team/partner should consider:

(i) whether the engagement team is competent to perform the audit engagement and has the necessary time and resources; and

(ii) whether XYZ & Co and the engagement team can comply with other ethical requirements, such as independence.

Given that XYZ has been the auditor of HKP since its incorporation, XYZ & Co need not revise its previous assessment of the integrity of the principal owners, key management and directors, unless there have been significant changes in principal shareholders, key management or directors, or XYZ & Co has obtained new information indicating that the integrity of these persons are in doubt.

Given that XYZ has been the auditor of HKP since its incorporation, and given that the operations of HKP have not changed significantly during the last year, there is no indication that the firm or the engagement team would not be competent to perform the audit.

Provided that the firm and all members of the engagement team satisfy the independence requirements of the *Code of Ethics for Professional Accountants* (the *Code*), there is no indication that XYZ should not accept the 20X7 audit engagement of HKP.

In particular, the engagement team should assess the possible familiarity threat to compliance with the *Code* since the manager-in-charge of HKP's audit has not changed for the last five years.

If the familiarity threat is considered significant, the safeguard of rotation of the manager-in-charge (or even partner-in-charge) should be implemented.

(b) The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

In general, no particular response is required for a low assessed risk of material misstatement at the financial statement level, except that the engagement team should continue to maintain professional scepticism in gathering and evaluating audit evidence.

However, HKSA 240 (Clarified)*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* recognises that management is in a unique position to perpetrate fraud because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Therefore, even if the engagement team assessed the risk of material misstatement at the financial statement level due to fraud as low, the engagement team is required to perform audit procedures to respond to the (presumed) risk of management override of controls.

These audit procedures may include:

(i) the analytical review of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements to determine whether they are appropriate;

(ii) the analytical review of accounting estimates for biases that could result in material misstatement due to fraud; and

(iii) making inquiries of HKP's management to obtain an understanding of the business rationale for significant transactions, if any, that are outside of HKP's normal course of business or that otherwise appear to be unusual.

Answer 2

(a) Classification of the bank loans refers to the assertion that information about the loans is appropriately presented and described.

The risk of material misstatement in classification of bank loans is usually low, since the terms of bank loans are clearly set out in the loan agreements.

The circumstances in HKP's particular case are more complicated because they involve the uncommon case of breaches of covenants and waivers from banks subsequent to the reporting date.

Correct classification of the bank loans depends on whether there is relevant guidance in the financial reporting standards for such cases, correct interpretation of such guidance, if there is any, and appropriate application of the guidance to this particular case.

The risk of material mis-classification of the bank loans as current or non-current is assessed as high (or medium at least).

(b) Under the usual circumstance where no new loans were raised or refinanced during the year, the audit team may perform a minimal level of substantive procedures, such as analytical procedures and obtaining confirmation from the banks.

However, given the non-routine nature of this case, and given that a proper classification of the loans would involve a high level of technical competence in interpreting the relevant financial reporting, which is likely to involve professional judgment, a substantive approach would be more appropriate.

The appropriate substantive procedures would include:

(i) inspecting the loan agreements to determine the effects of the breaches of the covenants, including effects on HKP's obligations to repay the principal amounts;

(ii) asking the management for their reasoning in classifying the loans as current after the breaches, and assessing the validity of their treatment in accordance with relevant financial reporting standards;

(iii) obtaining confirmation from the banks that they have granted waivers to HKP, and reviewing the terms of the waivers to determine whether the waivers would, in accordance with the requirements of the relevant financial reporting standards, permit HKP to classify the loans as non-current;

(iv) re-calculating the apportionment of the amount between current and non-current in accordance with the requirements of relevant financial reporting standards after considering the effects of the waivers obtained from the banks;

(v) reviewing the final draft of the consolidated financial statements to check that the bank loans are presented in the appropriate classes of assets and properly disclosed.

(c) In accordance with HKSA 220 (Clarified), the engagement team would undertake appropriate consultation on difficult or contentious matters.

The engagement partner should be satisfied that members of the engagement team have undertaken appropriate consultation on the matter, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as the technical partner or a panel of partners.

The engagement partner should ensure that the nature and scope of, and conclusions resulting from, such consultations are documented and agreed with the party consulted; and that the conclusions resulting from the consultations have been implemented.

Since HKP is a listed company, the engagement partner should appoint a quality control reviewer to evaluate the significant judgments made by the engagement team, including the judgment in this case on the classification of the bank loans.

The engagement partner should not issue an auditor's report until the quality review is completed.

Answer 3

(a) Completeness of trade and other payables refers to the assertion that all liabilities in trade and other payables that should have been recorded have been recorded.

Under usual circumstances, the inherent risks of material misstatement in completeness (ie understating) of trade and other payables would be assessed as normal/medium and the auditor may expect the entity's internal controls to reduce the combined (inherent risk and control risk) risk of material misstatement to low.

Although HKP had experienced severe cash flow problems during the year ended 31 December 20X7, there is no indication that the risk of material misstatement in completeness of trade and other payables is particularly high.

Therefore, unless the engagement team suspects fraudulent reporting, which is not apparent from the information given, the engagement team may continue to assess the risk of material misstatement of all the assertions of HKP's trade and other payables as low, with the expectation that HKP's controls over trade and other payables are operating effectively.

[Candidates may draw other conclusions, provided that they can justify them.]

(b) Given that tests of controls have been performed in the last year and that there is no material difference in the assessed level of risk of misstatement, it would be most efficient for the engagement team to adopt a combined approach for the completeness of trade and other payables in this case.

The engagement team may use audit evidence about the operating effectiveness of the controls over the completeness of trade and other payables XYZ & Co obtained in last year's audit.

In this case, the engagement team should ask the management of HKP whether there have been any changes in the controls.

The engagement team should observe the operation of the controls or inspect documentary evidence to confirm the understanding of any such changes or absence of changes.

The engagement team should perform tests of control on those changes during the year.

For those controls that have not changed during the year, the engagement team may significantly reduce the extent of tests of controls since satisfactory tests of controls were performed in the previous year's audit.

Substantive procedures to perform in the current year may include:

(i) substantive analytical procedures, such as comparing inventory turnover and/or the ageing of trade payables with standard credit terms granted by suppliers/payables turnover;

(ii) asking the management to notify any changes in major suppliers and inspecting documentary evidence for management's representations/consistency with records;

(iii) re-calculating the casting of trade and other payables to ensure all ledger balances of trade and other payables have been included;

(iv) re-performing reconciliations of suppliers' statement to ledger balances.

Answer 4

(a) When the bank loans are reclassified as current, HKP will report a net current liability of HK$176,129,000 [HK$198,261,000 – HK$140,270,000 – HK$234,120,000].

A net current liability is an example of events or conditions which may give rise to business risks that individually or collectively may cast significant doubt about the going concern assumption as set out below.

HKP's inability to comply with the terms of bank loan agreements is another indicator or going concern issue.

While there are material uncertainties relating to the event or condition that may cast significant doubt on HKP's ability to continue as a going concern, it may not be appropriate to conclude that HKP should not use the going concern assumption when preparing the financial statements.

Under the going concern assumption, HKP is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.

Given that HKP had no intention to cease business and the banks had formally waived HKP's non-compliance with the loan agreements, there is no strong argument that HKP should not adopt the fundamental principle of assumption as a going concern in the preparation of financial statements.

(b) If the engagement partner is satisfied that adequate disclosure about the going concern issue is made in the financial statements, the engagement partner need not qualify the audit opinion.

However, the engagement partner should add an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on HKP's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters.

The emphasis of matter may read as follows:

'Without qualifying our opinion, we draw attention to Note 1(c) in the financial statements which indicates that the Group incurred a net loss after tax of HK$23,151,000 during the year ended 31 December 20X7 and, as of that date, the Group's current liabilities exceeded its current assets by HK$176,129,000 because bank loans of HK$234,120,000 have been classified as current liabilities as a result of breaches of covenants during the year. These conditions indicate the existence of a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern.'

[Candidates may opine that an unqualified opinion be issued, but they have to justify their position.]

CASE STUDY 10 (May 2007)

Answer 1

(a) XYZ & Co's ethical obligations in relation to the change in auditors of EMM are governed by the *Code of Ethics for Professional Accountants* ("the *Code*"). In particular, XYZ & Co should comply with the requirements of Section 441 "*Change of Auditors of a Listed Issuer of the Stock Exchange of Hong Kong*" since EMM is listed on the Hong Kong Stock Exchange.

According to section 441 of the Code, XYZ & Co should prepare a Letter of Resignation addressed to the audit committee and the board of directors of EMM.

The Letter of Resignation should disclose all the occurrences that, in the opinion of XYZ & Co, affect the relationship between EMM and XYZ & Co. Such occurrences include, but are not limited to, "disagreements" and/or "unresolved issues".

According to the Code, ABC & Co. should make a request in writing to XYZ & Co to ask if there are any unusual circumstances surrounding the proposed change which ABC & Co. should be aware of, so that ABC & Co. may determine whether it should accept the nomination.

On receipt of the written request, XYZ & Co should act expeditiously. If there are no professional or other reasons why ABC & Co. should not accept the nomination, XYZ & Co should reply accordingly without delay.

If XYZ & Co considers it appropriate to discuss EMM's affairs with ABC & Co., XYZ & Co should request EMM's permission to do so freely. If permission is not granted, XYZ & Co should report that fact to ABC & Co. (who should not accept the nomination).

If, in the opinion of XYZ & Co, there are matters of which ABC & Co. should be made aware, XYZ & Co should inform ABC & Co. of those factors of which, in the opinion of XYZ & Co, ABC & Co. should be aware.

XYZ & Co may, for example, inform ABC & Co. that the reasons advanced by EMM for the change are not in accordance with the facts.

For example, XYZ & Co may inform ABC & Co. of the fact that it proposed a rotation of the engagement partner as an appropriate safeguard against the familiarity threat to independence, and that EMM did not accept the increase in audit fee.

If EMM are Hong Kong incorporated listed issuers, section 140A(2) of the Companies Ordinance requires an auditor who resigns from office before the expiry of his term must, if the resignation is to be effective, include in his resignation a statement of any circumstances connected with his resignation which he considers ought to be brought to the notice of members or creditors of the company, or a statement that there are no such circumstances.

(b) Risks of material misstatement at the financial statement level relate more pervasively to the financial statements as a whole and potentially affect many assertions.

These risks may be derived in particular from a weak control environment. In addition to a weak control environment, other conditions, such as (1) aggressive business strategies, (2) significant business risks arising from changes or complexity of business operations, or (3) unusually high pressures on performance measures and review.

The following facts may indicate a higher risk of material misstatement at the financial statement level:

(i) The integrity of the directors/management of EMM may be questionable since the reasons for change in auditors provided by XYZ & Co are different from those provided by the directors/management of EMM;

(ii) The plan to double the group's revenues within five years may be too aggressive;

(iii) The company has raised debt finance at a comparatively high interest rate of 9.5% per annum, indicating that the company is in "desperate" need of external funding to finance its aggressive expansion plan;

(iv) The company is listed on the Hong Kong Stock Exchange and an overseas stock exchange. The company is subject to greater pressure in its performance measures and review.

Answer 2

(a) In performing analytical procedures such as risk assessment procedures, the auditor develops expectations about plausible relationships that are reasonably expected to exist in accordance with HKSA 315 (Revised).

EMM is expanding. As a result, comparisons of current year data with prior-year data will show significant changes. The auditor, ABC & Co., has two important means of developing expectations about the financial statements. First, ABC & Co. can obtain industry information on comparable companies and ABC & Co. might also expect trends evidenced in prior audits to continue.

ABC & Co. then perform the following calculations:

Revenue/Receivables – 20X6: 3.25 times (20X5: 3.47 times); OR Receivable turnover days - 20X6: 112 days (20X5: 105 days) OR calculations of changes in sales vs. changes in trade receivables OR other reasonable calculations.

Ageing of trade receivables – 20X6: 57% within 60 days (20X5: 72% within 60 days) OR other reasonable calculations.

Summary presentation as follows:

	20X6	*20X5*
Revenue/receivables	3.25 times	3.47 times
Receivable turnover days	112 days	105 days
Ageing details		
Within 60 days	57%	72%
Between 61 days to 180 days	42%	25%
Over 180 days	1%	3%
	100%	100%

Revenue/receivables [or receivable turnover days] is a measure of whether a sound credit policy has been implemented. EMM's collection periods for the current year and the last year are longer than industry average. EMM's collection periods for both years are also beyond its normal credit period. The analysis may indicate an audit problem related to the uncollectibility of certain receivables (ie the valuation assertion).

Further breakdown shows an increase in receivable balances that exceed the normal credit period. This analysis may also indicate there may be inadequate allowance for uncollectible amounts (ie the valuation assertion).

A high level of the turnover days, together with pressure to report growth in revenues, might indicate higher risk of fraud in creating fictitious credit sales in the current period. The occurrence of sales during the year and hence the existence of trade receivables at the reporting date, would have a higher risk of misstatement.

(b) After the analysis, ABC & Co. needs to collect further information to verify the cause of the unexpected results such as the following:

(i) Changes in accounting practice and policy, for instance, the inclusion of debit balances on the creditors' ledger as receivables instead of deducting them from payables as before;

(ii) Whether there have been changes in EMM's management policy, for instance, a decision to allow customers to take extended periods of credit in order to double its revenue within five years;

(iii) Whether there have been changes in general commercial factors, for instance, a down-turn of the business climate in the industries in which EMM's customers are situated, hence rendering them unable to settle their debts within the credit terms;

(iv) Whether there are changes in specific commercial factors affecting only EMM, for instance, a higher proportion of EMM's products were sold on credit for the current year compared with last year;

(v) Whether there have been changes in policy on provision of bad debt allowances and the write off of bad debts;

(vi) Any indication of fraud, for instance, teeming and lading by employees.

[Note only four causes were required]

Answer 3

(a) Given that the risk of material misstatement of the existence of EMM's cash and cash equivalents is assessed as medium with an expectation that EMM's internal controls operated effectively during the period, it is reasonable for the team to adopt a combined approach in examining the existence of EMM's cash and cash equivalents.

Under the combined approach, the team should (1) perform tests of control to obtain appropriate sufficient evidence that the internal controls relevant to the existence of EMM's cash and cash equivalents had been operated effectively during the period, and

(2) perform substantive procedures to obtain further evidence that the risk of material misstatement is reduced to an acceptably low level.

(b) Control activities that are relevant to the existence of EMM's cash and bank balances include the following:

Control activities

(i) Periodic and timely reconciliation of the balances as shown in the bank statements against the records of cash and cash equivalents by a competent and independent staff (or other forms of performance review that related different sets of data to one another);

(ii) Automated or manual checking of the arithmetical accuracy of records (or other forms of application controls in the processing of information about cash transactions);

(iii) Physical access to cash and computer terminals and/or programs that process cash transactions are restricted to authorised persons (or other forms of physical control); and

(iv) Different persons are assigned the different responsibilities of authorising cash transactions, recording cash transactions and the custody of cash (or other forms of segregation of duties).

Monitoring of controls

(i) Management review of bank reconciliations to ensure that the reconciliations have been performed in a regular and timely manner; and

(ii) Internal auditors' review/independent review and evaluation of the effectiveness of physical controls over cash and/or extent of segregation of duties in processing cash transactions (or other relevant monitoring of controls).

[Note only two control activities were required]

(c) Tests of controls on the control activities that are relevant to the existence of EMM's cash and bank balances include the following:

Tests of controls on control activities

Any two of the following:

(i) Asking the relevant member of staff how he/she prepares the bank reconciliations to determine whether bank reconciliations are prepared properly.

(ii) Inspection of the documentation of the reconciliations during the year of the balances as shown in the bank statements against the records of cash and bank balances to obtain evidence that the reconciliations have been performed regularly and in a timely manner by a competent member of staff;

(iii) Obtaining evidence that the controls have operated effectively during the year, and re-performing the automated or manual checking of the arithmetical accuracy of records to identify any defects of the controls;

(iv) Observation of whether the physical access to cash and computer terminals and/or programs that process cash transactions are actually restricted to authorised persons; and

(v) Observation and/or inspection of documentation of which persons are assigned the different responsibilities of authorising cash transactions, recording cash transactions and custody of cash and cash equivalents.

Tests of controls on monitoring of controls

Any two of the following:

(i) Asking the management how he/she reviews the bank reconciliations to determine whether the reviews have been conducted properly;

(ii) Inspection of the documentation of management's review of bank reconciliations during the year; and

(iii) Observation and/or inspection of documentation of the internal auditors' review/independent review and evaluation of the effectiveness of physical controls over cash and/or the extent of segregation of duties in processing cash transactions, and determination of whether the internal auditors'/independent evaluation was appropriate.

(d) Obtain confirmation from banks in accordance with the requirements of HKSA 505 (Clarified) *External Confirmations*. In particular, the auditor should have full control over the confirmation process.

Review bank reconciliations for the bank balance as at 31 December 20X6, including inquiry into the nature of the major reconciliation items and inspection of documentation of the follow up actions and their disposal.

Perform analytical reviews on cash and cash equivalents records (including scanning through the records) to identify any unusual movements, particularly for short periods before and after the reporting date.

Check casting of the total cash and cash equivalents at the reporting date OR perform cash count and roll back to the reporting date if cash on hand was considered material.

Answer 4

The discovery of the fact that the general manager of one of the subsidiaries in EMM had misappropriated cash of HK$30,000,000 is a subsequent event under HKSA 560 (Clarified) *Subsequent Events*.

More specifically, it is an event occurring up to the date of the auditor's report.

According to HKSA 560 (Clarified), ABC & Co. should consider the effect of subsequent events on EMM's financial statements and on the auditor's report.

In this case, when ABC & Co. becomes aware of events which materially affect the financial statements, ABC & Co. should consider whether such an event is properly accounted for and where appropriate adequately disclosed in EMM's financial statements.

If the misappropriation occurred before the reporting date, it was an adjusting event according to HKAS 10 *Events after the Reporting Period*. Since the amount of HK$30 million was material with reference to profit for the year and probably also the cash balance of HK$1,220 million, the misappropriated amount should be adjusted in the financial statements in such a case.

If the misappropriation occurred after the reporting date, it was a non-adjusting event according to HKAS 10. Since the amount of HK$30 million was material to the profit for the year and probably also to the cash balance of HK$1,220 million, the misappropriated amount and the incidence should be disclosed in the financial statements in such a case.

In both cases, ABC & Co. should re-evaluate its assessment of the risk of material misstatement, in the cash balances in particular and in other account balances and classes of transactions in general.

The misappropriation of cash may indicate a deficiency or an override in EMM's internal controls that ABC & Co. should have identified and properly dealt with in the course of the audit.

Subsequent identification of the misappropriation may also suggest ABC & Co. has erred in assessing the risk of material misstatement or in determining the nature, extent and timing of tests of controls or substantive procedures.

If there is no indication that ABC & Co. had erred, subsequent identification of the misappropriation may suggest the existence of a higher risk of material misstatement due to fraud that cannot reasonably be identified through usual audit procedures according to HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

In such a case, ABC & Co. may need to change the nature, scope and timing of further audit procedures in accordance with the guidelines in HKSA 240 (Clarified).

If, after performing the necessary further audit procedures, ABC & Co. identifies other misstatements that should be adjusted or disclosed, ABC & Co. should request that EMM makes the adjustment and/or disclosure in the financial statements.

Glossary of terms

Accountability (agency) in this context accountability means that the agent is answerable under the contract to his principal.

Accountability (corporate) refers to whether an organisation (and its directors) are answerable in some way for the consequences of their actions.

Accounting estimate is an approximation of a monetary amount in the absence of a precise means of measurement.

Adverse opinion should be expressed when the effect of a **disagreement** is so **material and pervasive** to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent. In other words, in a company, the shareholders are actually the owners (the principal) of the company, who delegate decision-making authority to the senior management (the agents). Since the interests of the managers are not always in line with those of shareholders, they may act in a way that is detrimental to the company as a whole.

Agreed-upon procedures assignment. In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on **factual findings**. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. No assurance will be expressed on the financial information.

Alignment of interests is accordance between the objectives of agents acting within an organisation and the objectives of the organisation as a whole. Alignment of interests is sometimes referred to as goal congruence, although goal congruence is used in other ways.

Analytical procedures are tests conducted during an audit designed to help an auditor understand an entity's business and any likely areas of misstatement.

Anomaly is defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Applicable criteria are the criteria used by the responsible party when compiling the pro forma financial information.

Application controls are manual or automated procedures that specifically operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, they relate to specific procedures used to initiate, record, process and report transactions or other financial data.

Applied criteria. The criteria applied by management in the preparation of the summary financial statements.

Appropriateness is the measure of the **quality** or **reliability** of the audit evidence.

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditors to consider the different types of potential misstatements that may occur.

Audit of financial statements: the process to enable the professional accountant to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, giving a true and fair view of the entity's financial position at the period end and of the results of its operation for the period ended. An audit of financial statements is an example of an assurance engagement.

Audit file is one or more folders or other storage media in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Audit trail (also known as an **audit log**) is a chronological record of procedures in an information system which provides documentary evidence of the activities which have taken place in that system.

Assurance engagement: engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria.

Attestation engagement where the accountant declares that a given premise is either correct or not.

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions reached. The terms "working papers" or "work papers" are also sometimes used.

Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

Auditor's expert: an individual or entity possessing special skill, knowledge and experience in a particular field other than accounting and auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. They may be either an auditor's **internal** expert or an auditor's **external** expert.

Audit plan: converts the audit strategy into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Audit sampling involves the application of audit procedures to less than 100 per cent of the items within an account balance or class of transactions such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the entire population. Audit sampling can be applied using either a statistical or non-statistical approach.

Audit software is used by auditors to interrogate an entity's data and files. It may be generic audit software or custom audit software and will be used to carry out substantive procedures.

Audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Audit trail (also known as an **audit log**): a chronological record of procedures in an information system which provides documentary evidence of the activities which have taken place in that system.

Auditor's point estimate or auditor's range is the amount, or range of amounts respectively, derived from audit evidence for use in evaluating management's point estimate.

Business risk is the risk inherent to the entity in its operations. It is risks at all levels of the business. It is split into three categories.

Cold review: is a peer review carried out after the audit report is signed.

Comparative financial statements are amounts and other disclosures of the preceding period included for comparison with the financial statements of the current period, but **do not form part of the current period financial statements**.

Comparative information is the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Compilation engagement. An engagement in which a practitioner applies accounting and financial reporting expertise to **assist management in the preparation and presentation of financial information** of an entity in accordance with an applicable financial reporting framework, and reports as required by this HKSRS. No assurance will be expressed on the financial information.

Compliance risk is the risk that arises from non-compliance with the laws and regulations that surround the business.

Component auditor: an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool.

Contingent fees (or percentage 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.

Control activities are those policies and procedures which are established to achieve the entity's specific objectives and are designed to prevent, or to detect and correct errors.

Control environment: the framework within which operational controls operate. Its effectiveness is very much determined by management's attitudes, awareness of risk and actions and the importance placed on internal control within the entity.

Control risk (CR) is the risk that a material misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal controls.

Corporate governance is the system by which companies are directed and controlled.

Corresponding figures are amounts and other disclosures for the preceding period **included as part of the current period financial statements**, which are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

Date of the auditor's report is the date the auditor dates the report on the financial statements in accordance with HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements*. This date cannot be earlier than the date on which the auditor has obtained sufficient appropriate audit evidence for forming the audit opinion and the date of approval of the financial statements.

Date of the financial statements is the date of the end of the latest period covered by the financial statements.

Date the financial are issued is the date that the auditor's report and audited financial statements are made available to third prties.

Deficiency in internal control. This exists when a control is designed, implemented or operated in such a way that it is **unable to prevent, or detect and correct**, misstatements in the financial statements on a timely basis; or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is **missing**.

Detection risk (DR) is the risk that the auditors' procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

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 a trust over which the individual or entity has control

Direct reporting engagement, where the accountant reports on issues that have come to his attention during the course of his review.

Disclaimer of opinion: should be expressed when the possible effect of a **limitation on scope** is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. Or in rare cases, the auditor is not able to form an opinion on the financial statements due to the potential interaction of the multiple uncertainties and their possible cumulative effect on the financial statements.

Due diligence reviews are a specific type of review engagement. A typical due diligence engagement is where an adviser (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers. When a company is taken over or merged, all parties need to be assured that what is purported to be actually is. It can be carried out by actuaries, surveyors or lawyers. Normally, a takeover is not completed until a due diligence report has been completed.

Electronic commerce (e-commerce) means conducting business electronically via a communications link.

Electronic data interchange (EDI) is a form of computer to computer data transfer. Information can be transferred in electronic form, avoiding the need for the information to be re-inputted somewhere else.

Element of financial statement or "**element**" means an "element, account or item of a financial statement".

Emphasis of matter: in certain circumstances, an auditor's report may be modified by adding an **emphasis of matter** to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph **does not affect** the auditor's opinion. The auditor may also modify the auditor's report by using an emphasis of matter paragraph to report matters other than those affecting the financial statements as such importance that they are fundamental to users' understanding.

Error means either control deviations, when performing tests of control, or misstatements, when performing substantive procedures.

Estimation uncertainty refers to the **susceptibility of an accounting estimate** and related disclosures to an inherent lack of precision in its measurement.

Exceptions are responses that indicate a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

Expected error is the error that the auditor expects to be present in the population.

Expected misstatement is the misstatement that the auditor expects to be present in the population.

Experienced auditor refers to an individual who has practical audit experience and a reasonable understanding of the audit processes, accounting and legal requirements, the business environment and the auditing and financial reporting issues relevant to the entity's industry.

Fair: information is free from discrimination and bias and in compliance with expected standards and rules. The financial statements should reflect the commercial substance of the entity's underlying transactions.

Fair presentation framework – this term is used to refer to a financial reporting framework that requires **compliance with the requirements of the framework** and:

(i) acknowledges that to achieve fair presentation of the financial statements it may be necessary for management to provide disclosures beyond those specifically required by the framework

(ii) acknowledges that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements (extremely rare circumstances).

Fiduciary duty is a duty imposed upon certain persons because of the **position of trust and confidence** in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflicts of interest.

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.

Financial risks are the risks arising from the financial activities or financial consequences of an operation, for example, cash flow issues or overtrading.

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage. Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business.

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. It aims to establish a framework of overall control over the computer information system's activities. They commonly include controls over data centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

Going concern assumption: an entity is viewed as continuing in business for the foreseeable future with neither the intention to liquidate or cease trading or has no realistic alternative. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

Group engagement partner: the partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Group engagement team: partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group-wide controls are controls designed, implemented and maintained by group management over group financial reporting.

Hot review: is a peer review carried out before the audit report is signed.

Inconsistency exists when other information contradicts information contained in the audited financial statements.

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 scepticism had been compromised.

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 scepticism.

Indirect financial interests are beneficially owned through a collective investment vehicle such as trust over which the individual or entity has no control.

Information system relevant to financial reporting is a component of internal control that includes the financial reporting system. It consists of the use of standard or non-standard journal entries used to initiate, record, process and report transactions and also to maintain accountability for the related assets, liabilities and equity.

Information technology audit, or **information systems audit**, is an examination of the management controls within an information technology (IT) infrastructure. They were also formerly called "**electronic data processing** (EDP) audits".

Inherent risk (IR) is the susceptibility of an account balance or class of transactions to a misstatement that may be material either individually or when aggregated with other misstatements, based on the assumptions that there are no related internal controls.

Integrity means **straightforward dealing and completeness**. Financial reporting should be honest and should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.

Internal audit function. A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

Internal auditing is an appraisal or monitoring activity established within an entity as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of components of the accounting and internal control systems.

Internal control is the process designed and implemented by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Joint audit: one "where two or more auditors are responsible for an audit engagement and jointly produce an audit report to the entity".

Lien: a supplier's right to retain possession of a customer's property until the customer pays what is owed to the supplier.

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

Lowballing is the term used to describe the situation where a firm quotes a significantly lower fee for an assurance service than would be charged by a competitor firm usually in order to gain other more lucrative business.

Management are persons with executive responsibility for the conduct of the entity's operations.

Management bias is a lack of neutrality by management in the preparation of information.

Management's expert is an individual or entity possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Management's point estimate is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

Material inconsistency: may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

Misappropriation of assets is a particular type of fraud involving the wrongful taking an entity's assets.

Misstatement is a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from **error or fraud**.

Money laundering is a process by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activities. It is a way in which money earned from criminal activities ("dirty money") is transferred and transformed so it appears to have come from a legitimate source ("clean money"). Money laundering includes a wide range of potential crimes including possessing, dealing with, or concealing the proceeds of crime.

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions.

Negative assurance is assurance of something in the absence of any evidence arising to the contrary. In effect, this means the auditor is saying, "I believe that this is reasonable because I have no reason to believe otherwise".

Non-compliance refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Non-executive directors are directors who do not have day-to-day operational responsibility for the company. They are not employees of the company or affiliated with it in any other way.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures, or the auditor might misinterpret evidence and fail to recognise a misstatement or deviation.

Non-statistical sampling is the approach to sampling where the auditor does not use statistical methods and draws a judgmental opinion about the population.

Opening balances are those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Operational risks are the risks arising with regard to operations, for example, the risk that a major supplier will be lost and the entity will be unable to operate.

Other information is financial and non-financial information *other than* the financial statements and the auditor's report, which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.

Other matter paragraph: a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Outsourcing is the use of external suppliers as a source of finished products, components or services. It is also known as sub-contracting.

Peer review: a review of an audit file carried out by another partner in the assurance firm.

Performance materiality means the amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. (HKSA 320 (Clarified) Paragraph 9)

Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Population is the entire set of data from which a sample is selected and about which an auditor wishes to draw conclusions.

Predecessor auditor is an auditor from a different audit firm who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Pro forma financial information is financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for the purposes of illustration.

Prospectus is a document issued pursuant to legal and regulatory requirements relating to the entity's securities on which it is intended that a third party should make an investment decision.

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 entities.

Qualified opinion is expressed when:

(a) the auditor, having obtained sufficient appropriate audit evidence, concludes that **misstatements**, individually or in the aggregate, are material, but not pervasive, to the financial statements

(b) the auditor is **unable to obtain sufficient appropriate audit evidence** on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Related party. A party that is either:

(a) A related party as defined in the applicable financial reporting framework (ie HKAS 24 (Revised)).

(b) Where the applicable financial reporting framework establishes minimal or no related party requirements:

   (i) A person or other entity that has control or joint control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity or is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

   (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries.

   (iii) Another entity that is under common control with the reporting entity through having:

      – common controlling ownership (ie parent, subsidiary or fellow subsidiary related)
      – joint ventures or being associates
      – owners who are close family members
      – common key management
      – ex-employee

Reasonable assurance in the context of an audit of financial statements is a high, but not absolute, level of assurance.

Review engagement: to enable a professional accountant to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the professional accountant's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

Risk assessment procedures are audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level.

Sampling risk arises from the possibility that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

Sampling units are the individual items constituting a population.

Service organisation: an organisation that provides services to another entity.

Significant component: a component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Significant deficiency in internal control: a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Significant risks are those that require special audit consideration.

Single financial statement or a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

Special purpose financial statements: financial statements prepared in accordance with a special purpose framework other than a general purpose framework.

Special purpose framework: financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

Stakeholders: any entity (person, group or possibly non-human entity) that can **affect** or **be affected by** the achievements of an organisation's objectives. It is a **bi-directional** relationship. Each stakeholder group has different **expectations** about what it wants and different claims upon the organisation.

Statistical sampling is any approach to sampling that involves random selection of a sample, and the use of probability theory to evaluate sample results, including measurement of sampling risk.

Stewardship refers to taking care of something (the company and its assets) which is owned by someone else (shareholders).

Stratification is the process of dividing a population into subpopulations, each of which is a group of sampling units, which have similar characteristics (often in monetary value).

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Substantive procedures are audit procedures performed to detect material misstatements at the assertion level. They are generally of two types:

- Substantive analytical procedures
- Tests of details of classes of transactions, account balances and disclosures

Sufficiency is the measure of the **quantity** of audit evidence.

Summary financial statements. Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.

Test data techniques are used for tests of controls. By inputting a sample of transactions or other relevant data into an entity's computer system, and comparing the results obtained with pre-determined results, an auditor is able to check that the entity's systems are processing data in the correct way.

Tests of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Those charged with governance' are the person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation is the rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Transparency means **open and clear disclosure** of relevant information to shareholders and other stakeholders, and not concealing information which may affect decision-making. It means open discussion, with a default position of information provision rather than concealment.

Trivial misstatements will have no impact on materiality and will be matters that are clearly inconsequential.

True: information is factual and conforms with reality. In addition, the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

Type 1 report is a report on the description and design of a service organisation's controls.

Type 2 report is a report on the description and design of a service organisation's controls and their operating effectiveness.

User entity is an entity that uses a service organisation and whose financial statements are being audited.

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.

Written representations are written statements by management provided to the auditor to confirm certain matters or to support other audit evidence. They do not include the financial statements, assertions or supporting books and records.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Note: **Key Terms** and their page references are given in **bold.**

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		Very useful	Useful	Not useful
1.	Learning focus	☐	☐	☐
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6.	HKFRS and HKAS margin references	☐	☐	☐
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10.	Topic recap diagrams	☐	☐	☐
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		Excellent	Good	Adequate	Poor
13.	Overall opinion of this Learning Pack	☐	☐	☐	☐

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Student Education & Training,
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