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

Module C
Business Assurance
Module Preparation Seminar (Part I)

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12 October 2018

Seminar Outline

Module C

- Subsequent events (HKSA 560)
- Audit reporting
  - HKSA 701 Communicating key audit matters in the independent auditor's report
  - HKSA 720 (Revised) The auditor's responsibilities relating to other information

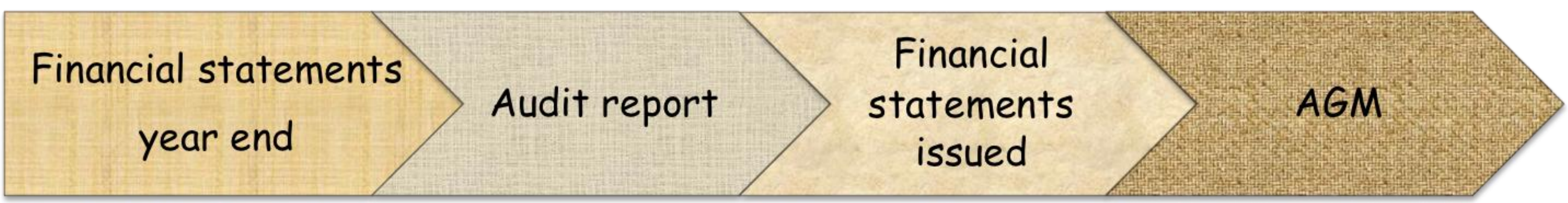
Questions and answer

SUBSEQUENT EVENTS (HKSA 560)

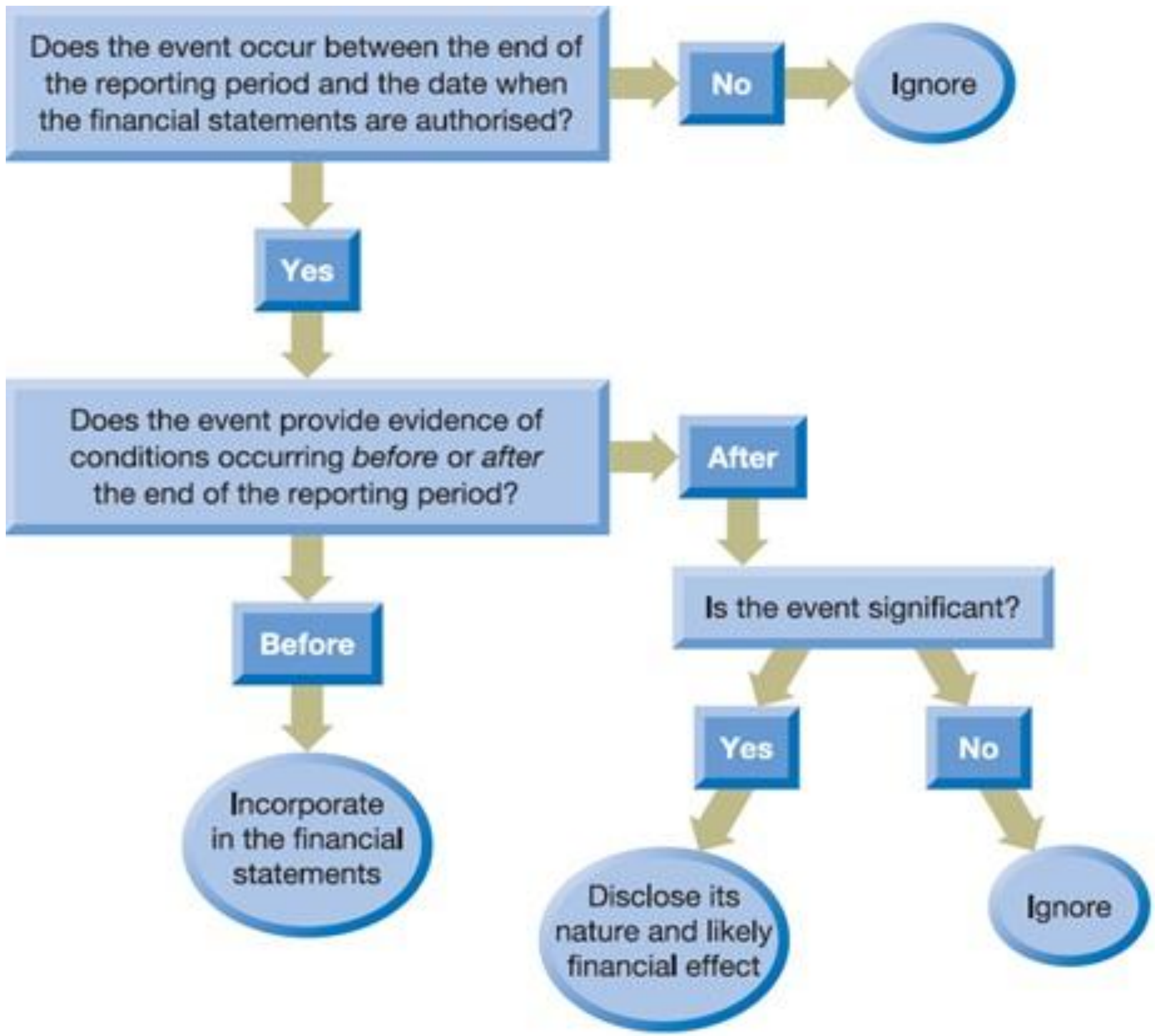
Definition

<u>Subsequent events</u> are events occurring

- Stage 1: between the date of the F/S and the date of the auditor's report
- Stage 2: facts discovered after the date of the auditor's report but before the F/S are issued
- Stage 3: facts discovered after the F/S are issued



HKAS 10 Events after the reporting period



Adjusting event

- Settlement of a court case
- Sale of inventory after year-end providing evidence of its NRV at year-end
- Fraud or error showing the accounts are incorrect
- Declaration of bankruptcy
- Subsequent collection of a large accounts receivable which had appeared doubtful of collection at the date of the F/S

Non-adjusting event

- Dividends declared after the year-end
- Fire causing destruction of major plant
- Announcement of a major restructuring
- Decline in market value of securities held for temporary investment
- Disposal after the date of the F/S of a large portion of the entity's productive assets

Stage 1

Auditor's responsibility

The auditor has the responsibility to *perform audit procedures* to obtain sufficient appropriate audit evidence for any subsequent events up to the date of the auditor's report if they may require adjustment of, or disclosure in, the financial statements have been identified.

Stage 1

Standard procedures:

- Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified
- Inquiring of management and those charged with governance as to whether any subsequent events have occurred which might affect the financial statements
- Reading minutes of the meetings that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available
- Reading the entity’s latest subsequent interim financial statements

Stage 1

Standard procedures:

- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation or claims
- Obtain evidence concerning any litigation or claims from the entity's counsel
- Obtain written representation that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed
- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence

Stage 2

Management's responsibility

Inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued

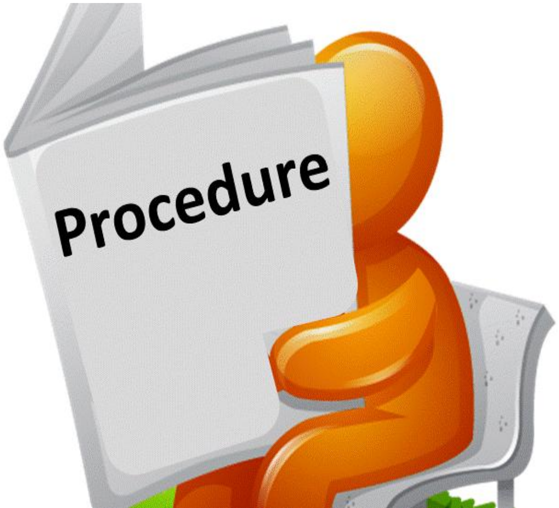
Auditor's responsibility

Do not have any obligation to perform procedures, or make enquiries regarding the financial statements, after the date of their report

Stage 2

…A fact becomes known to the auditor…, the auditor shall:

- Discuss the matter with management and those charged with governance,
- Determine whether the financial statements require amendment and,
- Inquire as to how management intends to address the matter in the financial statements.



Stage 2

If management <u>amends</u> the financial statements, the auditor shall:

- Carry out the audit procedures necessary in the circumstances on the amendment
- Extend the audit procedures to the date of the new auditor’s report
- Provide a new auditor’s report on the amended financial statements
- The new auditor’s report shall not be dated earlier than the date of approval of the amended financial statements

Stage 2

If management <u>does not amend</u> the financial statements: -

- If the auditor's report has **not yet been provided** to the entity, the auditor shall modify the opinion as required by HKSA 705 and then provide the auditor's report; or

- If the auditor's report has **already been provided** to the entity, the auditor shall advise management not to issue the financial statements to third parties before the necessary amendments have been made.

Stage 2

- If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

- The auditor's course of action to prevent reliance on the auditor's report on the financial statements depends upon the auditor's legal rights and obligations.

- The auditor may consider it appropriate to seek legal advice.

Stage 3

Management’s responsibility

Inform the auditors of any material subsequent events between the date of the auditors’ report and after the date the financial statements are issued

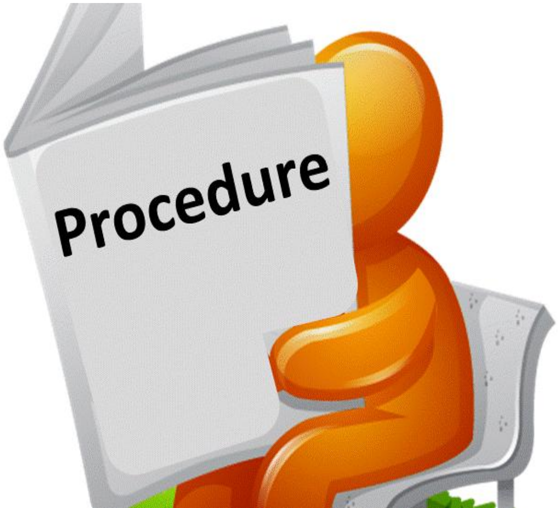
Auditor’s responsibility

No obligations to perform procedures or make enquiries regarding the financial statements after they have been issued

Stage 3

…A fact becomes known to the auditor…, the auditor shall:

- Discuss the matter with management and those charged with governance,
- Determine whether the financial statements require amendment and,
- Inquire as to how management intends to address the matter in the financial statements.



Stage 3

If management amends the financial statements, the auditor shall:

- Carry out the audit procedures necessary in the circumstances on the amendment

- Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation

- Extend the audit procedures to the date of the new auditor's report

Stage 3

- Date the new auditor's report no earlier than the date of approval of the amended financial statements
- Provide a new auditor's report on the amended financial statements
- Include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter(s) paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor

Stage 3

If management <u>does not amend</u> the financial statements: -

- The auditors shall notify management and those charged with governance that the auditor will seek to prevent reliance on their report.

- If management still does not act, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

June 2018

It has been agreed with Good Health that the auditor's report for the year ended 31 December 2017 will be issued in late June 2018. Just a week before the planned date of the auditor's report, you read a news headline "A popular product of Good Health is proven to contain carcinogenic substances with a high risk of triggering cancer as the raw materials were contaminated. Good Health announced an immediate product recall."

Required:

(a) Analyse and explain the risks of material misstatements to the financial statements in relation to the additional information provided above. No evaluation of the level of risk of material misstatements is required.

(6 marks)

June 2018

(b)Propose relevant audit procedures in response to the risks of material misstatements identified in Question (a).

(6 marks)

June 2018

(c) Determine and explain the obligation of ABC & Co to follow up on the news and assess the related financial statements impact if the news is only known by ABC & Co.

(i) On the date of the auditor's report but before the issuance of the 2017 financial statements.

(3 marks)

(ii) After the issuance of the auditor's report and the 2017 financial statements.

(3 marks)

HKSA 701 COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

Nature of KAM

Key audit matters (KAM)—Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

Reporting on KAMs aims to improve transparency by helping users to understand the most significant issues the auditor faced.

Nature of KAM

- KAMs are part of every **listed company** auditor’s report, and can be included by other auditors if needed.
- They are a part of the standard report which must be tailored to each company’s circumstances.
- KAMs must always relate to matters already included within the financial statements.
- KAMs are not a substitute for disclosures.

Nature of KAM

The reported KAMs do not include matters which have resulted in a modified opinion – any explanations in relation to these issues would already have been included in the 'Basis for' modified opinion paragraph.

Objectives of auditor

HKSA 701.7

The objectives of the auditor are to (1) determine key audit matters and, having formed an opinion on the financial statements, (2) communicate those matters by describing them in the auditor's report.

1. Determine KAM

Matters that were communicated with those charged with governance

Matters that required significant auditor attention

Matters of most significance in the audit (KAMs)

1. Determine KAM

The auditor shall take into accounts the following:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with HKSA 315.

- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment.

- The effect on the audit of significant events or transactions that occurred during the period.

1. Determine KAM

HKSA 701 notes that these ‘matters of most significance’ may be the ones that there has been most discussion with management about.

Other things to consider when determining KAMs include:

- The importance of the matter to intended users’ understanding, including materiality
- The nature of the underlying accounting policy relating to the matter of the complexity or subjectivity involved

1. Determine KAM

- Any misstatements related to the matter, and the nature and materiality of the misstatements
- The nature and extent of audit effort needed to address the matter
- The nature and severity of difficulties in applying audit procedures, obtaining evidence or forming conclusions
- The severity of any control deficiencies
- Whether several separate issues interacted

2. Communicate KAM

KAMs are communicated in a separate subsection of the auditor's report.

a) The general introduction states that:

- These are the 'matters of most significance' and
- No separate opinion is provided on them because they are covered by the audit opinion

2. Communicate KAM

b)The description of each KAM:

- Why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM

- How the matter was addressed in the audit

- Reference to the related disclosure(s), if any, in the financial statements

2. Communicate KAM

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Goodwill

Under HKFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of XX as of December 31, 20X1 is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe certain assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographical area].

2. Communicate KAM

Our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

The Company's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

Relationship with HKSAs

HKSA 700

The KAMs are the key matters for the audit of the whole financial statements.

They are not separate auditor’s opinions for each little part of the financial statements, but merely further information on the process that led up to the opinion of the financial statements as a whole.

Relationship with HKSAs

HKSA 705

If the auditor is going to express a modified opinion, the description of the matter will be given in the 'basis for modified opinion' paragraph, so it is not included as a KAM in the report.

Where the auditor disclaims an opinion on the financial statements, a KAM section must not be included in the auditor's report.

Relationship with HKSAs

HKSA 570

Where there is a material uncertainty in relation to going concern, the matter should not be described as a KAM, but should be discussed in the 'Material uncertainty in relation to going concern' paragraph instead.

HKSA 706

KAMs do not overlap with Other Matter paragraphs because KAMs must refer to issues present in the financial statements, whereas Other Matter paragraphs do not by definition.

Relationship with HKSAs

HKSA 706

An Emphasis of Matter (EOM) paragraph is not a substitute for a description of individual KAMs.

The difference between EOM paragraph and the KAMs is that KAMs do not modify the report, and are included as standard in every listed company auditor's report. An EOM does modify the report.

Where a matter has been included in an EOM paragraph, it must not be included as a KAM as well.

Relationship with HKSAs

Emphasis of Matter

We draw attention to Note X of the financial statements which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

June 2018

Max Sports Limited ("Max") is a listed company in Hong Kong. Recently, Max has acquired a fitness centre business for a consideration of HK$33 million. Upon acquisition, a goodwill of HK$30 million resulted. At the year end date, the management performed an impairment testing on this goodwill by comparing its carrying amount to an estimated fair value. The fair value was estimated by management based on the future cash flow of this business. Because of its significance and complexity, the auditor of Max has communicated to Max's audit committee their work done relating to the management's impairment assessment of goodwill. The following was communicated by Max's auditor during the audit committee meeting:

June 2018

"A goodwill of HK$30 million resulted based on the purchase price allocation. Management performed an impairment test on this goodwill at the year end by comparing the goodwill to its fair value. The fair value was derived from a cash flow forecast of the acquired business based on certain key assumptions that require significant judgement, including future profitability of the business. We have performed the necessary work to obtain an assurance that the impairment test and results are satisfactory. This is considered to be a Key Audit Matter ("KAM")."

June 2018

Required:

In accordance with the relevant auditing standard, describe the considerations for the auditor of Max to determine the impairment assessment of goodwill as a KAM. In addition, describe the contents of KAM which are required to be communicated in the auditor's report of Max.

(5 marks)

HKSA 720 (REVISED) THE AUDITOR'S RESPONSIBILITIES RELATING TO OTHER INFORMATION

Definition

<u>Other information</u> is financial or non-financial information included in an entity's annual report.

<u>A misstatement of the other information</u> exists when the other information is incorrectly stated or otherwise misleading.

Auditor’s responsibility

The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

The auditor shall make appropriate arrangements with management to obtain the other information prior to the date of the auditor’s report.

If it is not possible to obtain all the other information prior to the date of the auditor’s report, the auditor shall read such other information as soon as practicable.

Procedures

1. Any material inconsistency?

The auditor shall read the other information and

- Consider whether there is a material inconsistency between the other information and the financial statements.
- Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit.

Procedures

2. Identified material inconsistency

The auditor shall discuss the matter with management and perform other procedures to conclude whether:

- A material misstatement of the other information exists;
- A material misstatement of the financial statements exists; or
- The auditor's understanding of the entity and its environment needs to be updated.

Procedures

3. Actions

Material misstatement in financial statements

- The auditor must obtain evidence about the misstatement by performing further procedures. This may involve obtaining a better understanding of the entity in line with HKSA 315.
- The misstatement would then be evaluated in line with HKSA 450.

Procedures

3. Actions

Material misstatement in financial statements

- If the financial statements are materially misstated and are not amended, then the auditor's opinion would be modified as appropriate in line with HKSA 700.

- If the material inconsistency is only identified after the auditor's report has already been issued, then the guidance given in HKSA 560 applies.

Procedures

3. Actions

<u>Material misstatement in other information</u>

- Ask management to revise other information
- If management refuses, ask those charged with governance
- If still not corrected, then consider effect on audit report or withdraw from engagement
- If auditor will not be able to evaluate its validity, the auditor should consider whether management's rationale implies a lack of management integrity
- May obtain legal advice

Procedures

3. Actions

<u>Material misstatement in auditor's understanding</u>

Respond in line with other HKSAs

Procedures

4. Audit reporting

The auditor's report shall include a separate section with a heading ‘Other Information’:

- For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information; or
- For an audit of financial statements of an entity other than a listed entity, the auditor has obtained some or all of the other information.

Audit reporting

Other information

The directors are responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Audit reporting

Other information

Management is responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.] The X report is expected to be made available to us after the date of this auditor’s report.

Our opinion on the financial statements does not cover the other information and we will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above when it becomes available and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

Audit reporting

Other information

The directors are responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described below, we have concluded that such a material misstatement of the other information exists.

[Description of material misstatement of the other information]

Audit reporting

Other information

The directors are responsible for the other information. The other information comprises the [information included in the X report, but does not include the consolidated financial statements and our auditor's report thereon.]

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

Audit reporting

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described in the *Basis for Qualified Opinion* section above, we were unable to obtain sufficient appropriate evidence about the carrying amount of ABC's investment in DEF as at 31 December 20X1 and ABC's share of DEF's net income for the year. Accordingly, we are unable to conclude whether or not the other information is materially misstated with respect to this matter.

Audit reporting

Other information

The directors are responsible for the other information. The other information comprises the [information included in the X report, but does not include the consolidated financial statements and our auditor's report thereon.]

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

Audit reporting

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. As described in the Basis for Adverse Opinion section above, the Group should have consolidated DEF Company and accounted for the acquisition based on provisional amounts. We have concluded that the other information is materially misstated for the same reason with respect to the amounts or other items in the X report affected by the failure to consolidate DEF Company.

Companies Ordinance

Inconsistencies in complying with disclosure of information

Section 406(2) states that if a company's auditor is of the opinion that the information in a directors' report for a financial year is not consistent with the financial statements for the financial year, the auditor:

- must state that opinion in the auditor's report
- may bring that opinion to the members' attention at a general meeting

Companies Ordinance

Business review

If the company's auditor is of the opinion that the information in a directors' report for a financial statements is not consistent with the financial statements for the financial year, the company's auditor:

- has a duty to state that opinion in the auditor's report and

- may bring that opinion to the members' attention at a general meeting.

Example

The audit of ABC Co is at the finalization stage, with the auditor’s report due to be issued in the next week. To be included with the financial statements is a lengthy statement by the company’s chairman in which are to be found the following two statements.

It is claimed that revenue is $102m. This was the figure in the draft financial statements, but the audited financial statements will show a figure of $90m.

It is stated that it is likely that the company will win a case in which it is to be taken to court by a customer for damages resulting from some faulty products. The financial statements include a provision for these damages of $3m.

Required:

For each of the above situations, explain the matters for the auditor to consider, any further actions and the effect on the auditor’s report.

Example

Revenue

Example

Legal case

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