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Section 1 - Basics of Audit Responses

Reference: HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks*

Concept Check:

- What is the relationship between risks of material misstatement and audit response?
- Can you differentiate the following terms?
  - Audit Response
  - Audit Approach
  - Audit Procedures

Responses to RoMM at the Assertion Level

HKSA 330 (Clarified) requires that the auditor shall design and perform further audit procedures whose **n**ature, **t**iming and **e**xtent ("NET") are based on and are responsive to the assessed risks of material misstatement at the assertion level.

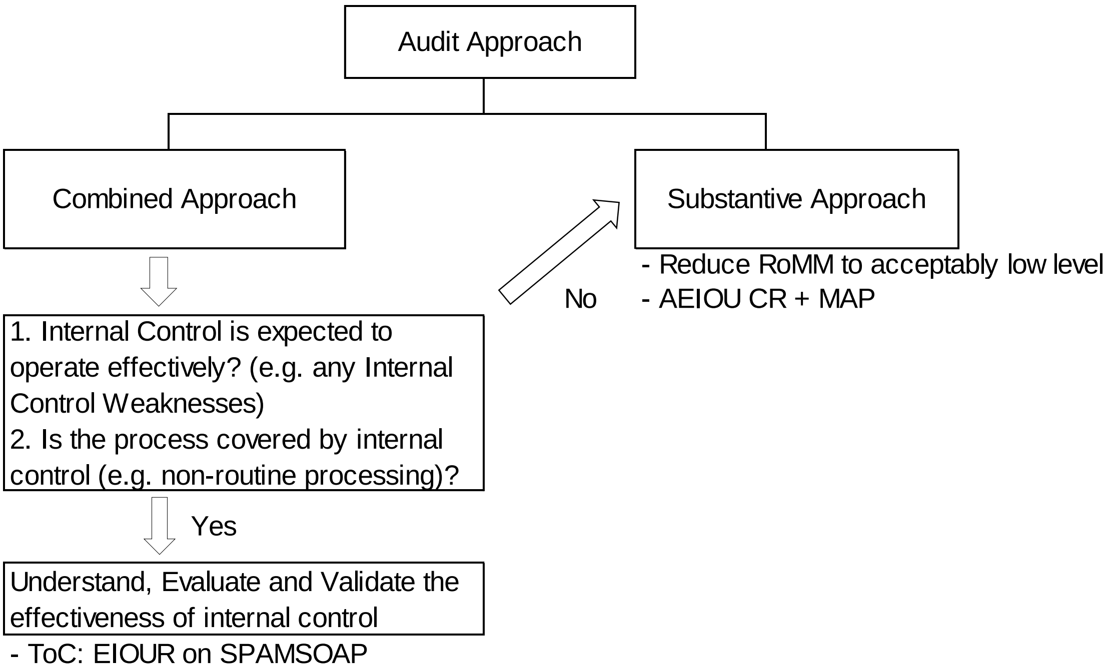
Nature	It refers to the audit approach and what type of audit testings would be performed.
Timing	It refers to whether to perform audit procedures at interim stage or at period end. Typically, if the RoMM is higher, audit procedures should be performed nearer or at period end or at unpredictable times.
Extent	It refers to the quantity of audit evidence. Typically, the higher the RoMM the greater extent is required. One way to increase extent is by increasing sample size.

Audit Approach

Approach	**Remark**
Substantive Approach	Only substantive procedures would be performed. Nevertheless, the auditor may perform one or in combination of test of details and substantive analytical procedures.
Combined Approach	Perform both tests of controls and substantive procedures.

In essence, the key determination factor is: are we going to perform tests of controls? The determination of audit approach can be illustrated by the following flowchart:

Determine Audit Approach



Types of Audit Testings

Before going further, we first look at how auditors can obtain audit evidence (mnemonic "AEIOU CR"):

Techniques	Remarks
Analytical Procedures	▪ Cannot address existence and occurrence ▪ Useful for valuation and allocation, accuracy and completeness
Enquiry	▪ Useful for most assertions
Inspection	▪ Useful for most assertions
Observation	▪ Useful for physical assets
Recalc**U**lation and reperformance	▪ Useful for valuation and allocation and accuracy
Confirmation	▪ Useful for most assertions (except for valuation and allocation of accounts receivables)
Reconciliation	▪ Cannot address existence and occurrence ▪ Useful for valuation & allocation, accuracy and completeness

The above techniques can be applied when performing audit testings.

Type	Remark
Tests of Controls ("ToC") Typically this involved "EIOUR".	Perform if: ▪ The auditor expects the internal controls are operating effectively and intends to rely on internal controls; or ▪ Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level (e.g. relate to the inaccurate or incomplete recording of routine and significant items by highly automated processing) If ToC is performed at interim: ▪ Obtain audit evidence about any significant changes subsequent to interim (by inquiry, observation and/or confirmation) ▪ Determine the additional audit evidence for the remaining period If using prior year's ToC results: ▪ Obtain audit evidence about any significant changes subsequent to prior year (by inquiry, observation and/or confirmation) ▪ If there have been changes, ToC should be performed again this year ▪ If there have been no changes, ToC should still be performed at least once in every third audit. Also, some ToC should still be performed each year. ▪ Prior year's ToC result should not be used if the controls relate to significant risks.
Substantive Procedures This covers all AEIOU CR.	This must be performed for: ▪ each material class of transactions, account balances and disclosures to reduce RoMM to acceptably low level ▪ significant risks Substantive procedures can be: ▪ tests of details or ▪ substantive analytical procedures

Designing Specific Audit Procedures ("AEIOU CR")

It is virtually not possible to list out all audit procedures to address each item by assertions. In fact, the audit procedures to address the same assertion of the same item would vary according to the specific circumstances.

Nevertheless, the below "MAP" approach would prove to be useful which makes use of "AEIOU CR" model.

Approach	Sample Substantive Procedures
Test what **M**anagement has done (E, U)	▪ Enquire into/Discuss with management regarding [ascertain the assertions] ▪ Assess experience, competence, objectivity of staff/expert performing the [management's actions] ▪ Examine compliance of accounting policies with HKFRS ▪ Reperform/recalculate management's calculation
Auditor designed procedures (A, I, O, C, R)	***Basic procedures:*** ▪ Obtain reconciliations/breakdowns showing [……] ▪ Agree opening balance to prior year's audited F/S ▪ Agree closing balance to F/S ▪ Check mathematical accuracy of the [accounting record] ***Main procedures:*** ▪ Vouch [supporting documents] for breakdown/movement items ▪ Vouch or Physically Observe from list to floor ▪ Vouch or Physically Observe from floor to list ▪ Send confirmations to [….] confirming [….] ▪ Test reconciliating items by vouching […..] and obtain explanations…. ▪ Review minutes and correspondence for…. ▪ Review agreements for….. ▪ Analytical Procedures (Compare A to B…) ▪ Search for unrecorded liabilities ***Procedures involving Accounting Estimates or Fair Value:*** ▪ Assess reasonableness of models and assumptions used by management ▪ Develop an independent estimates and compare with management's calculations (may also use auditor's expert) ▪ Review subsequent events to assess reasonableness ▪ Obtain LoR to confirm [state specific matters]
Post balance sheet indication	▪ Check for any subsequent settlements

Practice Question 1 – QP MC May 07 (extract)-Q3

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 2006, 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 turnover 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 turnover and receivables has been noted.

On 21 December 2006, 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 2006 after it reported on EMM's financial statements for the year ended 31 December 2005. However, XYZ & Co resigned in November 2006.

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 2007 and proposed to appoint them as the auditor of EMM's financial statements for the year ended 31 December 2006.

(i) EMM's consolidated balance sheet at 31 December 2006 is as follows:

(HK$'000)	**2006**	**2005**
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

(HK$'000)	2006	2005
Share capital	423,835	423,835
Share premium and reserves	910,425	805,075
Minority interests in assets and 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:

(HK$'000)	2006	2005
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:		
Turnover/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 income statement for the year ended 31 December 2006 is as follows:

(HK$'000)	2006	2005
Turnover	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
Minority interests in profit or loss	21,597	20,559
	138,576	195,319

You are ABC & Co's audit manager.

QP MC May 07 (extract)-Q3

<u>Question 3</u> (15 marks - approximately 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)

QP MC May 07 (extract)-Q3

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.

Answer 3(b)
Control activities that are relevant to the existence of EMM's cash and bank balances include:

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 programmes 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).

Answer 3(c)
Tests of controls on the control activities that are relevant to the existence of EMM's cash and bank balances include:

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 deficits of the controls;
(iv) Observation of whether the physical access to cash and computer terminals and/or programmes 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.

<u>Tests of controls on monitoring of controls</u>

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.

<u>Answer 3(d)</u>

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 2006, including enquiry 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 balance sheet date.

Check casting of the total cash and cash equivalents at the balance sheet date OR perform cash count and roll back to the balance sheet date if cash on hand was considered material.

Practice Question 2 –

QP MC Dec 12 (extract)-Q6
Question 6 **(18 marks – approximately 32 minutes)**
In a recent dialogue with the Internal Audit, you understand that the Internal Audit has issued an unsatisfactory report on the bank reconciliation process of your client. The Internal Audit report indicated that there was significant control deficiency over the cash management process, and that the management processes and controls were not properly exercised by the operation team.

Required:
(a) Assess and explain the risk of material misstatement relating to the existence and valuation assertions of the cash and bank balance as at year end.
(3 marks)

(b) Suggest and explain the audit procedures you would perform in response to the risk of material misstatement identified in Question 6(a).
(7 marks)

QP MC Dec 12 (extract)-Q6
Answer 6(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.

Answer 6(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 and discuss with Internal Audit 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).

Practice Question 3 – QP MC Jun 13 (extract)-Q2

CASE

You are an audit partner of ABC & Co. One day in July 2012, your old friend, Thomas, called you and told you that Happy Toy Ltd. ("Happy Toy") was looking for a new auditor and would like to check if you are interested in taking up the audit engagement.

After performing some background search of Happy Toy, you arranged a meeting with the management of Happy Toy to understand more about the entity and its business.

Here are the notes that you have written down during the meeting with Happy Toy's management:

– Happy Toy listed on The Hong Kong Stock Exchange in 2001. Its principal business is toy manufacturing and trading.

– It has a manufacturing plant in Panyu, China, and two trading companies in Hong Kong and Macau respectively.

– It mainly produces soft toys for overseas customers in the US and Europe. Only approximately 10% of sales are transacted with local customers in mainland China.

– Its toy business has been shrinking after the Financial Tsunami in 2008. Competition is getting fierce. Customer orders from the US and Europe dropped significantly while there is the continuous increase in material and labour costs in the Mainland. Management has been struggling in this business environment.

– In 2010, Happy Toy started to diversify its business portfolio and acquired a shopping arcade in the west of Guangzhou. The shopping arcade brings a stable income to the group and has been profit-making.

– In 2012, Happy Toy further diversified its business portfolio by investing in property development. It acquired a property development company in Henan focusing on developing high-end residential housing.

– The acquisition of the Henan property project was completed in February 2012. Happy Toy paid a total consideration of HK$200 million. The asset acquired mainly represented a piece of land located in Henan. The management has engaged an external independent valuer to assess the fair value of the land. The valuation of the land as at the acquisition date was approximately HK$180 million. A goodwill of HK$40 million was recognized in relation to this acquisition after considering the liabilities of HK$20 million.

– Management is confident of their property project in Henan in view of the high growth of the property market in the Mainland. They also explained that their piece of land is located in a very good location because a highway and a train station will be built nearby.

– As at 30 June 2012, Happy Toy has HK$300 million bank borrowings with the maturity date due in September 2013.

Subsequent to the meeting, management has sent you their interim report. Here is an extract of Happy Toy's financial information as at 30 June 2012 and for the six months ended 30 June 2012:

Segment disclosures

For the six months ended 30 June 2012:

	Toy Manufacturing Business (HK$'000)	Property Rental Business (HK$'000)	Property Development Business (HK$'000)	Total (HK$'000)
Revenue	680,000	12,000	-	692,000
Operating Profit / (loss)	(5,000)	9,000	(1,000)	3,000

For the six months ended 30 June 2011:

	Toy Manufacturing Business (HK$'000)	Property Rental Business (HK$'000)	Property Development Business (HK$'000)	Total (HK$'000)
Revenue	850,000	11,600	-	861,600
Operating Profit / (loss)	(4,000)	8,500	-	4,500

Extract from financial statements:

	30 June 2012 (HK$'000)	31 December 2011 (HK$'000)
Goodwill	40,000	-
Investment property	200,000	200,000
Property, plant and equipment	160,000	162,000
Property under development	180,000	-
Inventories	6,500	8,000
Trade receivables	27,000	30,000
Cash and bank	27,000	280,000
Other current assets	5,000	4,800
Total assets	**645,500**	**684,800**
Trade payables	53,000	57,000
Other payables and accruals	23,000	2,000
Bank borrowings	300,000	300,000
Total liabilities	**376,000**	**359,000**

In early August 2012, Happy Toy would like to nominate ABC & Co. as their coming auditor for the financial year ended 31 December 2012.

QP MC Jun 13 (extract)-Q2

Question 2 **(20 marks – approximately 36 minutes)**

You have accepted Happy Toy's appointment as their auditor for the 2012 financial year audit. You are now working on the audit planning and risk assessment.

Required:

(a) **In respect to the property project in Henan, identify and explain the risks of material misstatements at the assertion level.**

[Note: Marks will only be given if you can provide specific answers to particular account balance(s) and related assertion(s).]

(7 marks)

(b) **In response to the risks of material misstatements identified in Question 2(a), what are your suggested audit procedures in addressing the risks?**

(13 marks)

QP MC Jun 13 (extract)-Q2 – Answer

Answer 2(a)

The following are the risks of material misstatements identified:

(i) Existence, valuation and right and obligation of the piece of land acquired

- The amount of the land acquired is material to financial statements and its valuation is highly dependent on the valuation results of the external independent valuer.

(ii) Valuation of the goodwill arising from the acquisition of the property development company

- The amount of goodwill recognized is individually material to the financial statements and highly dependent on the valuation results of the asset and liabilities acquired.
- Potential goodwill impairment depends on the future development of the property market in the Mainland and the timing of completion of the highway and train station.

QP MC Jun 13 (extract)-Q2 – Answer

Answer 2(b)

In response to the existence, valuation and right and obligation of the piece of land acquired, the following procedures should be considered:

- Inspect the share purchase agreement and ensure the land form part of the asset transferred
- Inspect the land use right certificate and ensure the title of the piece of land is under the company
- Carry out a site visit to inspect the piece of land acquired
- Inspect the valuation report prepared by the external independent valuer and discuss the findings in the valuation report with the valuer

- Evaluate the competence, capabilities and objectivity of the independent valuer to consider whether the work of the valuer is adequate for the audit purposes
- Evaluate the relevance and reasonableness of the independent valuer's findings and conclusions
- Evaluate the relevance and reasonableness of the significant assumptions and methods used by the independent valuer
- Evaluate the relevance, completeness and accuracy of the source data used by the independent valuer
- When it is determined that the work of the independent valuer is inadequate to satisfy the audit purposes, agree with the independent valuer the nature and extent of further work to be performed by the independent valuer or perform additional appropriate audit procedures

In response to the valuation of the goodwill arising from the acquisition of the property development company, the following procedures should be considered:

- Agree the consideration paid to the sales and purchase agreement by inspection
- Identify potential intangible assets and consider the valuation (e.g. due diligence reports)
- Consider whether asset and liabilities valuation (including assumptions) is reasonable
- Obtain the purchase price allocation and agree the calculation is correct by recalculation
- Check purchased goodwill is calculated correctly (it should reflect the difference between the fair value of the consideration given and the aggregate of the fair values of the net asset acquired)
- Review the impairment test performed by management at year end and discuss with management
- Evaluate the impairment test, ensure the methodology used is in compliance with the Hong Kong Financial Reporting Standard and the assumptions used are reasonable
- Check whether appropriate disclosures has been prepared in relation to the business combination and goodwill impairment assessment in the financial statements

Practice Question 4 – QP MC Jun 14 (extract)-Q6

<u>Question 6</u> (10 marks – approximately 18 minutes)

You are the auditor of Think Limited which is a furniture manufacturer with a factory in Dongguan, China. During the planning of the audit for the year ended 31 March 2014, you obtained the following financial information:

	2014	2013
	HK$'million	HK$'million
Revenue	525	285
Cost of goods sold	350	242
Gross Profit	175	43
Property, plant and equipment	425	495
Accounts receivable	232	75
Accounts payable	155	105

<u>Required:</u>

(a) Assess and explain the risk of material misstatement relating to the occurrence assertion of revenue for the year ended 31 March 2014.

(4 marks)

(b) Discuss and propose the audit procedures for the occurrence assertion of revenue.

(6 marks)

QP MC Jun 14 (extract)-Q6

Answer 6(a)

The risk of material misstatement relating to the occurrence assertion of Think Limited's revenue for the year ended 31 March 2014 is high as:

- The revenue significantly increased 84% from the prior year and there was no significant capital investment in Think Limited's property, plant and equipment to increase its production capacity.
- The gross profit margin increased from 15% to 33%. For manufacturing company, revenue should change in line with the cost of goods sold.
- The accounts receivable balances increased to 3 times of the same in the last year and the debtor turnover period (accounts receivable / revenue x 365 days) increased from 96 days to 161 days. It indicated that the revenue may be overstated by including non-exist debtors.

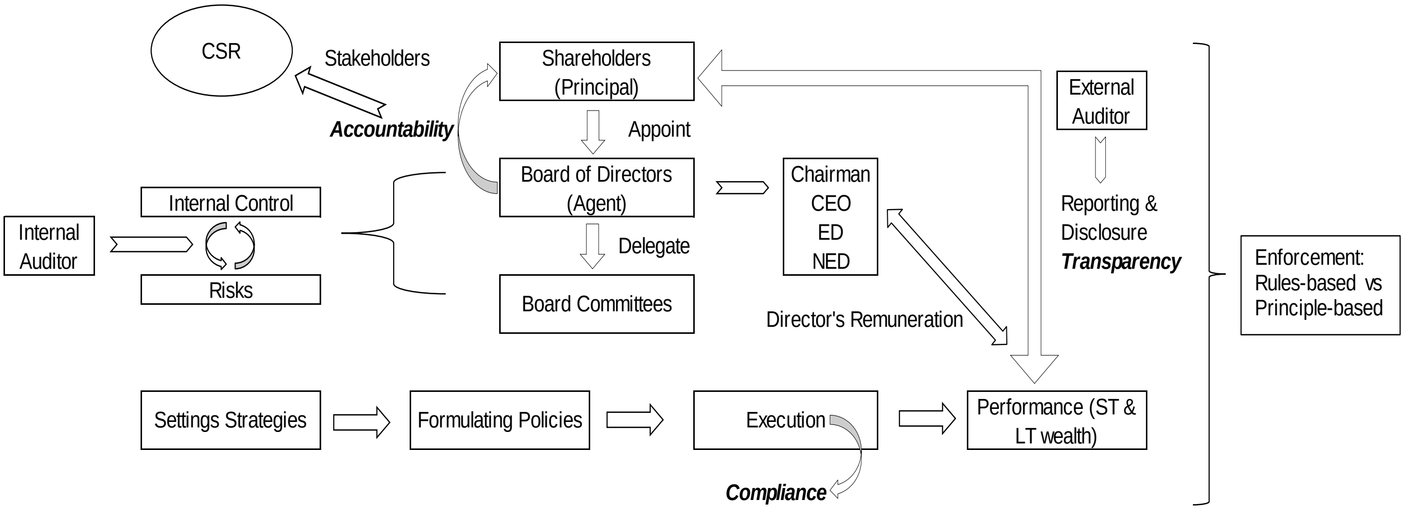
Answer 6(b)

The audit procedures for the occurrence assertion of revenue may include:

- Perform a financial analysis of the fluctuation of gross profit margin.
- Ask the management for the reasons for the fluctuation in gross profit margin with reference to the market situation.
- Perform an industry comparison and analysis to document whether the change in gross profit margin is in agreement with the current market trends and situation.
- Perform a walk through test and control test to ensure the effectiveness of internal controls implemented for the revenue cycle.
- Review whether the entity is following HKAS 18 "Revenue" and applies the revenue recognition policies consistently throughout the periods.
- Discuss with the staff at the operational level to ensure an understanding that the business operation procedure was correct and up to date and there are no key changes in the business operation procedures.
- Perform substantive procedures by selecting samples from the sales ledger and tracing them in goods delivery documents to ensure proper recording.
- Direct confirmation of customers to confirm the total sales amount for the year.

Section 2 – Corporate Governance Practice

Overview of Corporate Governance



Basics of Corporate Governance

Corporate governance is the system by which organisations are directed and controlled.

Poor corporate governance and fraud are two common root causes of corporate scandals. Sound corporate governance can reduce corporate failure by:

- encouraging reliable and complete external reporting, thereby increasing accountability and providing signals to investors
- identifying and managing the wide range of risks
- enhancing effective internal controls
- increasing investors' confidence
- attracting new investments

Corporate governance is relevant to auditor because:

- Corporate governance has direct impact on control environment, entity's risk assessment process
- Corporate governance can increase participation of TCWG
- Poor corporate governance may heighten business risks and eventually RoMM at the F/S level

Respective responsibilities on corporate governance are set out below:

Party	Responsibilities on Corporate Governance
Board of Directors ("BoD")	Have direct responsibilities, including: ▪ Ensure compliance of code of corporate governance or explain the reasons ▪ Perform a balanced, clear and comprehensive risk assessment ▪ Implement sound internal controls and review their effectiveness at least annually ▪ Review the need for internal audit annually. The review should cover all material controls, including financial, operational and compliance controls and risk management functions. ▪ Disclose (1-way) and maintain dialogue (2-way) with shareholders
Auditors	Does not have direct responsibilities ▪ Only responsible for truth and fairness of F/S ▪ Assess entity's implementation and compliance with good corporate governance practices as part of understanding of the entity and internal controls under HKSA 315 (Revised) ▪ Communicate with the board and audit committee on corporate governance matters ▪ Read corporate governance report as other information (see also HKSA 720 (Clarified)) ▪ May also be asked to check entity's compliance with codes of corporate governance

Principles of Corporate Governance

The below table sets out the key components of corporate governance which define the fundamental principles of a sound corporate governance structure (mnemonic "ACT II").

Components	Remarks
Accountability	Management is answerable to them in that they can be called to give an account for their behaviour and actions as agents of the shareholders. Management must act with the best interests of shareholders as they are ultimately responsible to them. Accountability is the key attribute to address agency problem.
Compliance	Management should ensure the entity complies with all laws and regulations whilst meeting corporate objectives. See also Chapter 6.
Transparency	All reports produced by the entity should be objective and supply relevant information, without concealment. Unless there is an overwhelming reason not to disclose information of any kind (perhaps for reasons of commercial sensitivity) then information should be disclosed or made available upon request to any interested stakeholder. This links to Disclosures, see Section 16.5.
Independence	Independence is a quality possessed by individuals and refers to the avoidance of being unduly influenced by a vested interest. Independence enables a more objective position. Non-executive directors, internal auditors and external auditors are free to express their opinions.
Integrity	Management should consider be honest and straightforward. Integrity is therefore a steadfast adherence to strict ethical standards despite any other pressures to act otherwise. Integrity can: · provides assurance of good intentions and truthfulness · reduces time and energy spent in monitoring · cultivates good working relationships

Corporate Governance Code in Hong Kong

In Hong Kong, corporate governance is currently addressed by Code on Corporate Governance Practices. This Code on Corporate Governance Practices sets out the principles of good corporate governance, and two levels of recommendations:

- Code provisions. Listed entities should comply or explain.
- Recommended best practices. They are for guidance only.

The structure of the Code is set out as follows:

Section	Remark
A. Directors	It mainly covers: ▪ function and composition of the board ▪ appointment, re-appointment, removal and resignation of directors ▪ induction of directors
B. Remuneration of Directors and Senior Management	It mainly covers: ▪ formation of remuneration committee ▪ components and objectives of director's remuneration
C. Accountability and Audit	It mainly covers: ▪ acknowledgement of responsibility for F/S preparation ▪ formation of audit committee ▪ maintenance and review of internal controls
D. Delegation by the board	It mainly covers board committees.
E. Communication with Shareholders	It mainly covers arrangements in annual general meetings ("AGM") and other general meetings.

Responsibilities of Board

The BoD has a number of responsibilities. The key ones include (mnemonic "SPSR"):

Responsibilities	Remark
Setting the company's **S**trategies	Essentially this involves: ▪ positioning company in dynamic markets (where we stand?) ▪ setting corporate direction (where we want to be?) ▪ budgeting resources (can we do it?) ▪ deciding implementation process (how we can do it?)
Formulating **P**olicies	Essentially this involves: ▪ stating purpose of company ▪ creating vision for expansion into potential areas ▪ creating value by improving business capability ▪ developing corporate climate and culture (link to Control Environment) ▪ monitoring opportunities, threats and risks
Supervising the management	Essentially this involves: ▪ overseeing management performance ▪ monitoring budgetary control ▪ reviewing key business results ▪ assessing organisational capabilities in resources and processes
Reporting	Typically this includes reporting to: ▪ shareholders ▪ regulators ▪ stakeholders

Composition of the Board
The board should consist of:

Board member	Remarks
Chairman	Chairman is typically a NED and generally acts in a supervisory capacity and is involved with the appointment of NEDs. In essence, chairman can be seen as the guardian of the board. Chairman's responsibilities mainly include: ▪ Ensure the board sets strategic objectives ▪ Represent company to outside world ▪ Maintain cordial relationship with CEO ▪ Determine structure, composition and succession of the board ▪ Co-ordinate and set agendas for meetings and manage meetings ▪ Ensure the board members receive information of discussion agendas ▪ Hold independent meetings with NED only ▪ Ensure AGM and shareholders' meetings are held at regular intervals
Chief Executive Officer ("CEO")	CEO is generally an executive director and appoints the executives to the board. In essence, CEO can be seen as the executive of the executives. Main responsibilities mainly include: ▪ Accountability toward the board for operations and performance. ▪ Develop and implement policy decisions and executing strategy. ▪ Implement proper risk, management, financial, operational, planning and internal control systems. ▪ Plan and manage financial and physical resources ▪ Monitor financial performance in accordance with budget ▪ Build and maintain strong management team and act as link between board and employees ▪ Act as representative of the company ▪ Assist in selection of board members
Executive Directors ("ED")	▪ Member of BoD and form part of the executing management team ▪ Involve in the day-to-day running of the business ▪ Have industry knowledge and expertise ▪ Usually paid a salary, performance-linked pay and share options
Non-Executive Directors ("NED")	▪ Member of BoD but do not form part of the executive management team ▪ Not employee of the company ▪ Listing rules require that at least one-third of the board should include independent NEDs. ▪ Entities are recommended to have at least three independent NEDs. ▪ As independent protectors of stakeholders and act in supervisory and monitoring role of executives ▪ Receive fixed annual fees

Importance of NED
NED plays an important role in corporate governance because they:
- are key members in board committees especially audit committee
- provide check and balance over the powers of ED and CEO

With their roles being monitoring and supervisory, it is crucial that NEDs are independent and free from conflict of interests.

Separation of Chairman and CEO
From the above, it can be seen that the roles of chairman and CEO are quite distinct. Chairman represents the shareholders whereas CEO represents the employees and managers.

It is very important that the position of chairman and CEO should not be held by the same person, otherwise there would be a concentration of power in the board.

This separation has the following benefits:
- avoid the dangers of unfettered power that may arise when power is concentrated in a single powerful individual
- increase accountability by protecting against CEO acting for his self-interest
- enhance the organisational effectiveness by allowing CEO and Chairman to execute their assigned roles
- provide a reassurance to investors and ensures compliance with relevant codes

The roles and duties of the chairman and CEO should be established in a written term of reference and agreed by the board.

Professional Development of Directors
Directors are key personnel of the entity. Therefore, it is important that they are equipped with adequate knowledge and updates.

In view of this, the directors should:
1. Receive proper induction process on joining the board (i.e. **on induction)**
2. Receive training to continually update their knowledge (i.e. **Continuous)**

Induction is a process of orientation and familiarisation that new members of an organisation undergo upon joining. Induction process for NEDs is arguably important because it can:
- help NEDs to better understand the nature of the company, its business environment and its culture
- communicate practical procedural duties to the new NEDs including company policies
- establish relationship between NEDs and company's key stakeholders including other directors
- help NEDs to understand the relationships with shareholders, auditors, major customers and suppliers

Continuous development programme is important because it can:
- update skills and knowledge about the entity's operations
- learn about any rules update such as compliance requirements and HKFRS
- learn about working with any new board members

Directors' Remunerations
Remunerations are the payments that directors receive for the services that they render under contracts of service. Remunerations should be determined by the remuneration committee.

Components of remuneration package may include:

Components	**Remark**
Basic salary	The amount is fixed.
Performance related bonus	This may be made reference to profits, EPS or shareholders' return. This provides performance incentives to ED but it is also a fraud risk factor (see Chapter 5). This must not be awarded to NEDs to ensure independence.
Share and share options	This may help reduce agency problem by aligning long-term interest between management and shareholders. Again, this provides performance incentives to ED but it is also a fraud risk factor (see Chapter 5). This must not be awarded to NEDs to ensure independence.
Benefits in kind	Typically this is to achieve better for tax efficiency.
Termination payments	This cannot be too high, otherwise the directors may be paid for failures.

The level of remuneration should be sufficient but not excessive. A balanced remuneration package is important because it can:

- reduce agency costs
- align with the interests of shareholders (i.e. directors are rightly rewarded for meeting the objectives of shareholders)

A balanced package should achieve (mnemonic "ARM"):

Purpose	Remark
Attract	Level is adequate to ensure that people with suitable skills and knowledge will find the post attractive. If too high: people with wrong skills may be attracted If too low: too few suitable applicants will be attracted
Retain	Level is adequate to prevent performing directors from seeking employment elsewhere in order to find a level of reward more suited to his or her skills and experience.
Motivate	Level is adequate to provide loyalty and a desire to achieve in the role.

Remuneration should always be linked to how well the director has contributed to the company's **long-term** strategies (and thus aligning with shareholders' interest).

When remuneration is linked to strategy:

- The director is motivated to perform well
- The executives are rewarded for their performance against the objectives of the company
- Performance of executives regarding development and implementation of strategies can be assessed

The Code recommends that a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Board Committees

Board committees are set up by the board to delegate certain areas that need to be considered without the pressure of executive directors. However, decision-making powers are generally not delegated. The ultimate decision-making responsibilities rest with the main board.

Board committees are formed so that:

- the board is absolved of the responsibility of monitoring certain areas
- time and resources of the board are used effectively
- the board can delegate certain time-consuming and detailed work to the committees
- the board can delegate certain areas where there may be conflict of interests

The below table summarises the roles and purposes of board committees:

	Remuneration Committee	Audit Committee	Nominations Committee	Risk Committee
Function	Discussing and approving remuneration of each director	Ensuring that financial reporting and internal control processes are appropriate	Recommending appointments of new directors and determining board structure	Assessing whether internal controls and risk management processes are in place

Composition	▪ Majority NEDs	▪ Entirely NEDs ▪ At least 3 NEDs	▪ Majority NEDs ▪ Chaired by Chairman	▪ Majority NEDs
Duties	▪ Develop remuneration policy ▪ Establish standards for performance - linked remuneration ▪ Ensure contractual terms of termination are clear ▪ Ensure termination payments are fair ▪ Suggest policies for the benefits of all employees	▪ See next section	▪ Make recommendation on appointment, re-election of directors to BoD ▪ Evaluate skills, knowledge and experience required for each position of the board ▪ Prepare job specification ▪ Establish terms and conditions for the appointment of EDs and NEDs ▪ Advice on the balance between EDs and NEDs ▪ Establish the appropriate numbers of BoD ▪ Monitor independence of NEDs ▪ Ensure diversity of backgrounds	▪ Review and approve risk strategies and policies ▪ Review key risk reports ▪ Monitor overall risk exposure ▪ Evaluate risk management system effectiveness ▪ Approve risk disclosures

16.4.1 Audit Committee

The main role and responsibilities should be set out in Written Terms of Reference, including:

Areas	**Responsibilities**
Financial Reporting	▪ Monitor the reliability of F/S and disclosures ▪ Monitor all formal declarations relating to financial performance (e.g. press release) ▪ Review significant financial reporting opinions (e.g. changes in accounting policies)
Internal Controls, including IA	▪ Review effectiveness of internal control and risk management systems ▪ Monitor the implementation of rectification of internal control deficiencies ▪ Appointment and termination of head of IA ▪ Review IA reports ▪ Monitor and review the effectiveness of IA
External Audit	▪ Liaison with external auditors for appointment, termination and fixing the remuneration and scope of work ▪ Open a communication channel for external auditor to discuss significant matters ▪ Review management's letter

Disclosures in the context of Corporate Governance

Transparency can be achieved by:
- One-way communication: Reporting and Disclosure
- Two-way communication: Dialogue in shareholder meetings

The general principles of communication are:
- **Reliable and accurate**. That is, the information is creditable.
- **Understandable**. Additional explanation is available where appropriate.
- **Timely**.

The Stock Exchange of Hong Kong Limited requires listed entities to include a CGR in their annual reports which sets out 2 levels of disclosure:

Type	Examples
Mandatory disclosure requirements Failure to include will be regarded as a breach of the Listing Rules.	· Statement of compliance with the Code, and explanation of any non-compliance · Directors' securities transactions · Details of BoD · Identity of Chairman and CEO · Terms of appointment of NEDs · Directors' remuneration policy · Nomination committee information · Auditor's remuneration committee · Audit committee information · Statement that the directors have at least annually conducted a review of internal control effectiveness
Recommended disclosure requirements Listed entities are encouraged to state whether they have complied.	· Division of responsibility between the · board and management · Outcome of annual review over the need of internal audit · Process that the entity has applied for identifying, evaluating and managing the significant risks faced by it · Acknowledgement by the board that it is responsible for the issuer's system of internal control and for reviewing its effectiveness · Process that the entity has applied in reviewing the effectiveness of the system of internal control · Process that an issuer has applied to deal with material internal control aspects of any significant problems

Practice 5 – QP MC Jun 12 (extract) –Q4

CASE

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 2011, 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 2011, the company reported that they have 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 2011 which caused particular concern to ABC & Co. In these reports by the Internal Audit, 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 due to certain significant controls over fixed asset registration and valuation were not properly exercised by the operation team.

Question 4 **(14 marks – approximately 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)**

QP MC Jun 12 (extract) –Q4

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, balance sheet 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.

Answer 4(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.

Answer 4(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. need 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 weaknesses 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.

Practice Question 6 – QP MC Jun 14 (extract) – Q8

Question 8 **(8 marks – approximately 14 minutes)**

Peace Limited is a company listed on the Hong Kong Stock Exchange and has entered into an agreement with Mr. Chan, an executive director of Peace Limited, for consultancy services. Pursuant to the agreement, Peace Limited will pay HK$10 million to Mr. Chan for general consultancy services such as promoting the image of Peace Limited in the market.

Required:

Suggest the corporate governance measures required (ignoring the Hong Kong Listing Rules requirements on connected transactions) to enhance the transparency of transactions with directors in Peace Limited.

(8 marks)

QP MC Jun 14 (extract) – Q8

Answer 8

The Hong Kong Stock Exchange sets out the principles of good corporate governance in the Code on Corporate Governance Practices ("the Code") included in the Appendix of the Main Board Listing Rules. The recommended corporate governance measures Peace Limited should consider include:

(1) Composition and balance of the board of directors

A single individual may bypass the board to action his own interest. The board should include directors with proper knowledge and experience in assessing the reasonableness of material transactions entered into by Peace Limited. The mix between executive and independent non-executive director should also be balanced to allow a proper review of management activities.

(2) Audit committee

Peace Limited is a company listed on the Hong Kong Stock Exchange. It must establish an audit committee according to the listing rules. An audit committee should be established to review Peace Limited's internal financial controls. The Code has already a requirement that the Audit Committee should be independent from the management. The committee should also be kept abreast of the information and developments in Peace Limited's as a monitoring measure against contract with directors.

(3) Remuneration Committee

The Code requires the establishment of a Remuneration Committee, consisting of the majority of independent executive directors, to approve the remuneration of directors and executives. A reasonable remuneration package for the management is usually a general measure to prevent senior management from acting for self-interest or committing wrong-doings at the expense of the company's interest.

(4) Other measures

Typical corporate governance measures also include an employee whistle-blowing scheme where employees are encouraged to report exceptional or suspicious related party activities e.g. fraud or collusion and corporate governance issues. Peace Limited should consider establishing such a communication channel.

Practice 7 – QP MC Jun 15 (Extract) – Q6

Question 6 **(8 marks – approximately 14 minutes)**

Excellent Limited is a company listed on the Hong Kong Stock Exchange. Excellent Limited is engaged in construction projects contracted by certain reputable real estate developers. Recently, the directors of Excellent Limited were aware that one of its key construction projects may face a significant delay in completion. In accordance with the terms as set out in the respective construction contract, the customer has the right to claim against Excellent Limited for any loss arising from such delay. Based on the project team's estimation, the claim may amount to HK$100 million.

Required:

From the corporate governance perspective, suggest actions that the directors of Excellent Limited should take.

(8 marks)

QP MC Jun 15 (Extract) – Q6

Answer 6

In Hong Kong, the Code on Corporate Governance Practices ("HK Code") sets out the principles of good corporate governance. It refers to the companies subject to the Code as "issuers".

The HK Code promotes transparency and openness. 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.

Directors should also hold responsibilities to their stakeholders. Directors should act in the best interests of the company and take the necessary steps to ensure the company stays on the right path.

Directors are accountable to stakeholders for complying with statutory and regulatory requirements, safeguarding funds and taking proper stewardship of assets and resources. Any major issues should be brought to the attention of the board on a timely basis. Financial and non-financial performance measures should be established and reported.

In this regard, the directors should understand thoroughly the status of the construction with the operational personnel, evaluate if a significant delay in the completion will likely to arise. Consider seeking expert advice from internal or external sources.

Concurrently, the directors should establish measures to respond to the possible losses. For example, try every effort to negotiate with their customer aiming to minimise the loss and damage to the company.

The directors should also assess the significance of the impact arising from the delay of the construction project and consider if a disclosure of the event is required. The impact can be a financial loss, which may cause a significant loss arising in profit or loss, and a non-financial loss, which is a reputation risk.

Section 3 – Group Audit

Concept check:
- What is the setting of group audit?
- What are the specific audit issues in a group audit setting?

Reference: HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*

Below are the basic definitions in a group audit:

Group financial statements are financial statements that include the financial information of more than one component.

Component is an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

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

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

Nature of Group Audit

The audit process in a group audit is in principle the same in a non-group audit. However, the fact the F/S is consolidated brings up additional audit considerations which are addressed by HKSA 600 (Clarified).

The objectives of the group auditor are:
(a) To determine whether to act as the auditor of the group F/S; and
(b) If acting as the auditor of the group F/S:
  (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and
  (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group F/S are prepared, in all material respects, in accordance with HKFRS.

Overview of Group Audit Process

Following on the previous section, the specific considerations required by HKSA 600 (Clarified) in the audit process are set out in the below table:

Stage	Responsibility of Group Auditor
Acceptance and Continuance	▪ Obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components Obtaining such understanding enable the group auditor to fulfil the requirements of HKSQC 1(Clarified) and whether sufficient appropriate audit evidence can be obtained on the group F/S.
Overall Group Audit Strategy and Audit Plan	▪ Review the overall group audit strategy and group audit plan Typically, the overall audit strategy and audit plan for a group is more excessive.
Understanding the Group, Its Components, and Their Environments	▪ Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage ▪ Obtain an understanding of the consolidation process, including the instructions issued by group management to components The understanding should be sufficient to: ▪ Confirm or revise its initial identification of components that are likely to be significant ▪ Assess the RoMM of the group F/S whether due to fraud or error

Determine significant components and work thereon	Please below for further discussion.
Assess Component Auditors	Please below for further discussion.
Testing Group-Wide Controls	Test (or request a component auditor to test) the operating effectiveness of group-wide controls if: ▪ NET of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively; or ▪ Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level
Determine Component Materiality	Please below for further discussion.
Issue Group Audit Instructions to Component Auditors	Please below for further discussion.
Involvement with Component Auditors' Work	Please below for further discussion.
Test Consolidation Process	This involves the testing of consolidation adjustments and making sure the consolidation F/S is complete.
Subsequent Events	Where component auditors perform work other than audits of the financial information of components: ▪ request the component auditors to notify the group auditor if they become aware of subsequent events that may require an adjustment to or disclosure in the group F/S
Communication with Group Management and Those Charged with Governance	This includes key group audit issue.
Basis of Group Audit Opinion	This is based on evaluation of whether sufficient appropriate audit evidence has been obtained from: ▪ the work performed by the group auditor; ▪ the work performed by the component auditors on the financial information of the components; and ▪ the audit procedures performed on the consolidation process
Forming Group Audit Opinion	The auditor's report on the group F/S shall not refer to a component auditor (even in the case of modification of opinion), unless required by law or regulation to include such reference. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group auditor's responsibility for the group audit opinion.

Determine Significant Components

Significant component is a component that is:
- of individual financial significance to the group; or
- due to its specific nature or circumstances (likely to include significant RoMM of the group F/S).

A percentage to a chosen benchmark (group assets, liabilities, cash flows, profit or turnover) may be applied as an aid to identify components that are of individual financial significance.

Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgement.

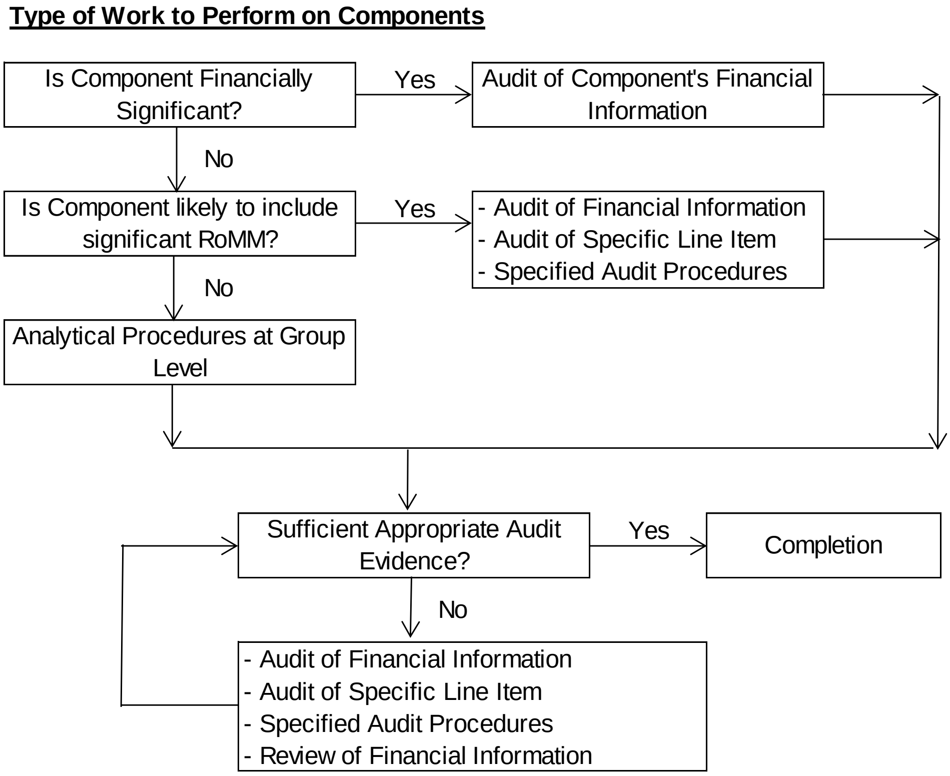
HKSA 600 (Clarified) does not set out a specific threshold. Nevertheless, HKSA 600 (Clarified) includes an example that components exceeding 15% of the chosen benchmark may be considered significant components. However, a higher or lower percentage may also be deemed appropriate depending on the circumstances.

Determine the Type of Work to be performed on Components

HKSA 600 (Clarified) sets out clear guidance as follows:

Circumstance	Type of Work
Significant component due to its individual financial significance	Perform an audit of the financial information of the component using component materiality
Significant component due to its specific nature or circumstances and may pose significant RoMM	Perform one or more of the following: ▪ An audit of the financial information of the component using component materiality ▪ An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant RoMM ▪ Specified audit procedures relating to the likely significant RoMM
Components that are not significant components	Perform analytical procedures at group level If the group engagement team does not consider that sufficient appropriate audit evidence will be obtained, then perform one or more of the following: ▪ An audit of the financial information of the component using component materiality ▪ An audit of one or more account balances, classes of transactions or disclosures ▪ A review of the financial information of the component using component materiality ▪ Specified procedures

The determination of type of work can be summarised by the following flowchart:



Assessing Component Auditors

The findings of component auditors will be used by group auditor as basis to form the group audit opinion. Therefore, it is crucial for the group auditor to ensure the creditability of the component auditors.

In particular, the group auditor should assess the following areas in respect of the component auditors:

Areas to assess	**Group Auditor's Procedures**
Compliance with ethical requirements, in particular, independence (independent from the parent company and its related parties)	▪ Seek confirmation from the component auditor regarding their independence, objectivity and professional competence ▪ Visit the component auditor to discuss about their independence, objectivity and professional competence ▪ Request the component auditor to complete questionnaires about their independence, objectivity and professional competence ▪ Obtain confirmations from the professional bodies whether the components are professional qualified and licensed with those professional bodies ▪ Ascertain the quality control policies and procedures used by the component auditors, both firm-wide and those applied to individual engagements ▪ Obtain and review the ethical codes followed by component audit firms and compare them to Code of Ethics for Professional Accountants issued by HKICPA
Objectivity, including any bias or conflict of interest	
Professional competence, including: ▪ Understanding of HKFRS and HKSA ▪ Sufficient expertise and experience in the component's industry audit	

If there are any issues, the group auditor should increase the NET of involvement in the component auditors' work, including:

- Supervise the component auditor directly and review their working papers
- Review in details the component auditors' findings and evaluate the appropriateness of their conclusion

The group auditor should also consider to perform the audit work themselves instead of using the component auditors.

<u>Group and Component Materiality</u>
The group auditor shall determine the following:

Types of Materiality	Remark
Materiality for the group financial statements as a whole	The principle is the same as normal audit.
Materiality level(s) to be applied to particular classes of transactions, account balances or disclosures (also known as Specific Materiality)	The principle is the same as normal audit.
Component materiality	Component materiality is for those components where component auditors will perform an audit or a review for purposes of the group audit. Component materiality shall be lower than materiality for the group F/S as a whole. Where component auditors will perform an audit for purposes of the group audit, the group auditor shall evaluate the appropriateness of performance materiality determined at the component level.
The threshold above which misstatements cannot be regarded as clearly trivial to the group F/S	The principle is the same as normal audit.

<u>Group Instructions and Reporting Package</u>
After the group auditor determined the type of work in respect of each component, he should send a group instruction to each component auditor.

The group instruction typically includes the following:
- the work to be performed by the component auditor
- the use to be made of that work
- the form and content of reporting to the group auditor
- Reporting timetable
- Accounting policies to be applied at the component level
- A request that the component auditor returns an acknowledgement of receipt
- The ethical requirements that are relevant to the group audit and, in particular, the independence requirements
- Component materiality, specific materiality and the threshold above which misstatements cannot be regarded as clearly trivial to the group F/S (in the case of an audit or review of the financial information of the component)
- Identified significant RoMM of the group F/S due to fraud or error that are relevant to the work of the component auditor
- A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware

Following the completion of work, the component auditors would report their findings to the group auditor.

The group reporting package typically includes the following:
- Whether the component auditor has complied with ethical requirements including independence and professional competence
- Whether the component auditor has complied with the group instruction;
- Identification of the financial information of the component on which the component auditor is reporting
- Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group F/S
- 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 TCWG
- Any other matters that may be relevant to the group audit
- The component auditor's overall findings, conclusions or opinion

Involvement with Component Auditors

The group auditor is ultimately responsible for the group audit opinion which encompasses the work performed by the component auditors. Therefore, the group auditor should:
- Determine whether he will be able to be involved in the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence
- Involve with the work performed by the component auditors, especially when the component auditors identify audit issues that are relevant to the group F/S

The group auditor can get involved with component auditor's working by:
- Discuss with the component auditor or component management of the component's business activities and environment
- Discuss with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error
- Review the component auditor's documentation of identified significant RoMM of the group F/S
- Review the component auditors' overall audit strategy and audit plan
- Discuss significant matters with the component auditor, component management or group management, as appropriate
- Understand any audit issues (e.g. limitation of scopes, misstatements) identified by the component auditors and assess their impact on group F/S based on group materiality
- Determine whether it is necessary to review component auditor's audit documentation

The involvement by the group auditors should be conducted on a timely basis.

Practice 8 - MC Dec 12 (Extract) – Q7

Question 7 **(17 marks – approximately 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 2011 audit. Solid Inc. is a multinational company with annual turnover 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 that 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 that you do not have much information about the local auditor in terms of competence, independence and objectivity.**

(7 marks)

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Answer 7(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.

Answer 7(b)

Given the component is now audited by a local auditor that you do not have much information about the local auditor in terms of competence, independence and objectivity, 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 about 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; and
- 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.

END