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# EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD



# About the Lecturer



## **Ms Fiona Lam**

**Managing Director and Principal Lecturer – MC & MD**

*FCA(UK), FCCA, FAIA,  
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- ❖ **Practising partner of a medium size firm**
- ❖ **Practical experience in corporate governance, risk management, auditing and tax**
- ❖ **Professional training over 10 years and has been teaching MC & MD since then**
- ❖ **Taught over 10000 students**

# Module C – Business Assurance



## Module Preparation Seminar – Agenda

- Identifying and assessing the risks of material misstatement at financial statement and assertion level (HKSA 315 (Revised 2016))
- Responses to assessed risks (HKSA 330)
- Corporate governance code and corporate governance report



# HKSA 315 (Revised 2016)

**Identifying and assessing the risks of material misstatement at financial statement and assertion level**

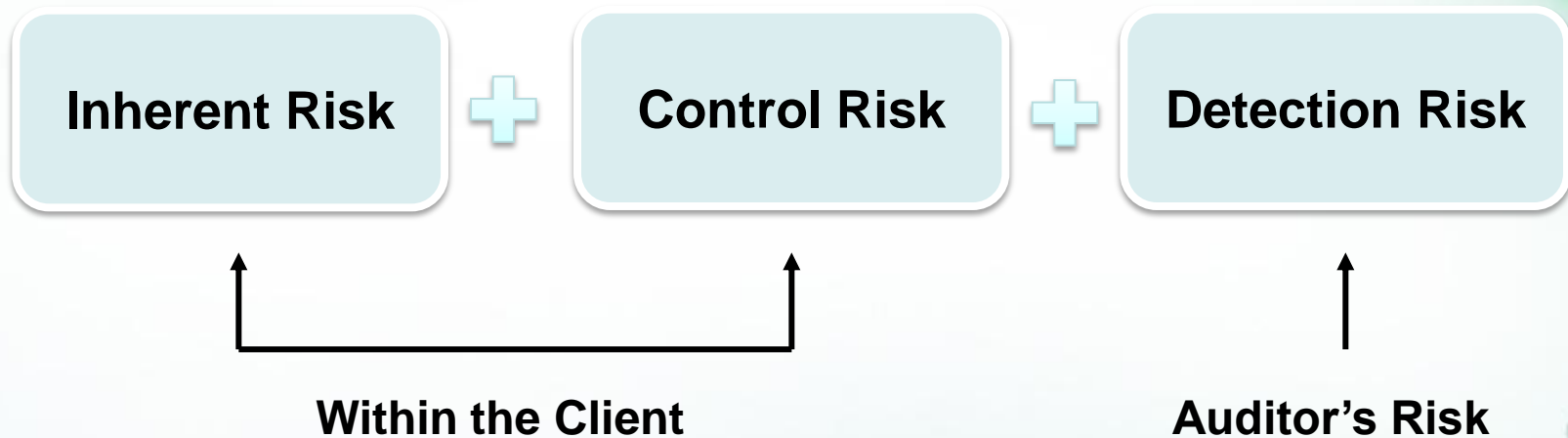


# MC – HKSA 315 (Revised 2016)



## Audit Risk - Definition & Components

It is “risk that auditor expresses an inappropriate audit opinion when the financial statements are materially misstated taken as a whole”





# MC – HKSA 315 (Revised 2016)



## Inherent Risk (“IR”)

- Refers to the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were **no related internal controls**.
- Example:
  - Industry environmental factors – competitiveness
  - Technological obsolescence or over-dependence on single product
  - Accounts which require expert valuations

# MC – HKSA 315 (Revised 2016)



## Control Risk (“CR”)

- Refers the risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, **will not be prevented or detected and corrected** on a timely basis by the accounting and **control systems**.
- If the company has good internal controls, there is a **high chance** that the control system will detect a material error.



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## Detection Risk (“DR”)

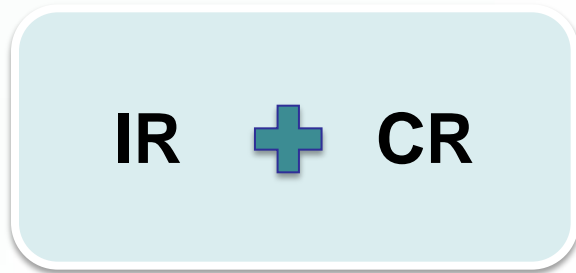
- Refers risk that the **auditor will not detect a material misstatement** that exists in an assertion where the audit procedures fail in its effectiveness. Auditor should amend his NET (Nature, Extent and Timeliness) of the audit procedures.
- Sampling risk and non-sampling risk are components of detection risk.
- Eg Incoming auditor – ie not familiar with the audit client

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## Inverse Relationship

**Combined  
Assessment of risk**



**More Audit  
Work**



**Assertion Level**



**Perform Risk Assessment  
only on IR and CR**



# MC – HKSA 315 (Revised 2016)



## HKSA 315 (Revised 2016) Risk Assessment

Why revised the standard? As there are changes in HKSA 610 (Revised) related to internal auditors

### Risk Assessment Procedures and Related Activities

#### a) Inquiries of Management, the Internal Audit Function and Others within the Entity

- auditor can obtain information through inquiries with the **internal audit function**, if the entity has such a function
- Inquiries directed to **the risk management function**
- Inquiries directed to **information systems** personnel may provide information about system changes, system or control failures

# MC – HKSA 315 (Revised 2016)

## HKSA 315 (Revised 2016) Risk Assessment



### b) Inquiries of the Internal Audit Function

- the internal audit function is likely to **have obtained insight into the entity's operations and business risks**, and may have findings based on its work, such as identified control deficiencies or risks
- internal audit function provides information to the auditor regarding any **actual, suspected or alleged fraud**

### c) Considerations specific to public sector entities

- Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying **the risk of material non-compliance with applicable laws and regulations** and the **risk of deficiencies in internal control** over financial reporting.



## d) Audit Evidence for Elements of the Control Environment

- The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies
- The auditor may also be able to use the work of the internal audit function to modify the **n**ature or **t**iming, or reduce the **e**xtent, of audit procedures



# MC – HKSA 315 (Revised 2016)

## HKSA 315 (Revised 2016) Risk Assessment



Requirement: (Must perform)

1. Identify and Assess the risks of material misstatements **at the (Overall) financial statement level** and at the **assertion level** for classes of transactions(P/L), account balances (B/S) and disclosures.
2. Determine risks that require **special audit consideration** and consider whether the controls are implemented (**“Significant Risks”**)



# MC – HKSA 315 (Revised 2016)

## HKSA 315 (Revised 2016) Risk Assessment



3. Evaluate the design of entity's controls and determine the implementation of the entity's controls
4. If is **not possible** or impracticable to reduce the risks of material misstatements at the assertion level to an acceptably low level with audit evidence obtained by substantive testing, then auditor should evaluate the design and implementation of the client's controls i.e. in a computerized system, lack of paper trail

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## Risk of material misstatement at Financial Statement Level – General

- Applying to the financial statement as a whole
- Able to reduce audit risk to an acceptably low level
- More pervasive to the financial statement at a whole
- **Affect many assertions**

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## Risk of material misstatement at Financial Statement Level – Factors to consider

\*\*\* Always related to management\*\*\*

- Risks from a weak control environment which includes management's attitudes to good internal control practice
- Management's attitude towards a good internal control
- Management's competence, integrity and experience

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## Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Unusual pressures** on management (i.e. plan to go public, bonuses ties to sales or profits)
- Nature of entity's business – risky Industry, market fluctuations
- Industry factors i.e. **Special regulations and reporting changes** (i.e. Listing companies, securities companies, insurance companies, banks)



## Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Aggressive business strategies** – fast expansion, plenty of acquisition and mergers
- **Significant business risk**
  - Cannot focus on a specific risk
  - Concern about the client's going concern
  - Concern about fraud



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## HKSA 330 Responses to assessed risk – FS Level

- Reduce audit risk to an acceptability low level, auditor should determine overall responses to assessed risks of material misstatements at the financial statement level and **documentation is required**
- Consider Control Environment



# MC – HKSA 315 (Revised 2016)



## HKSA 330 Responses to assessed risk – FS Level

### \*\*\*\* Use general audit strategy \*\*\*

For Example:

- Assigning more staff or more training for staff
- More supervision for staff
- Emphasizing to audit staff the need to maintain professional skepticism

# MC – HKSA 315 (Revised 2016)



## HKSA 330 Responses to assessed risk – FS Level

- Collect more persuasive evidence and more procedures
- Using experts
- Incorporating more unpredictability into the audit procedures
- Change nature, extent and timeliness of substantive tests

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## Risk of material misstatement at Assertion Level

- **Not able** to reduce the risks of material misstatement to an acceptably low level with audit evidence obtained only from substantive procedures
- Refer to specific **classes of transactions, accounts balances**
- Risks arise from the particular characteristics of a class of transaction – **inherent and control risk**
- Identify controls that are likely to **prevent, detect or correct** material misstatements

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## Risk of material misstatement at Assertion Level – General

- Comprises of IR and CR (**Combined Assessment of the Risk of Material Misstatements**)
- Auditor would perform **tests of controls** to support the risk assessment

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## Risk of material misstatement at Assertion Level – Factors to consider

- Accounts likely to be susceptible to misstatements (i.e. required many adjustments in previous year's audit or accounts that include estimated amounts)
- **Complexity of underlying transactions** (i.e. financial instruments)
- Degree of judgement involved in determining account balances (i.e. provision for contingent liabilities and warranty expenses)
- Susceptibility of assets to loss or misappropriation



# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion Level – Responses

- **Design and perform appropriate audit procedures to address** to the assessed risks of material misstatements at the assertion level and for each material class of transactions, account balances and disclosure.
- Determine risks that require special audit considerations and consider whether the controls are implemented
- Evaluate the design of entity's controls and determine the implementation of the entity's controls Vouching etc
- **Documentation of N(Nature) E(Extent) T(Timeliness) \*** of further audit procedures, linkage of those procedures with



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## N – Nature of Substantive Testing

- Consider performing Substantive Testing only or both
- Tests of controls and substantive testing
- Type such as inspection, observation, inquiry etc
- Use **Substantive Approach** – Perform only substantive testing
- Use **Combined Approach** – Use both test of control and substantive testing

# MC – HKSA 315 (Revised 2016)



## E – Extent of Substantive Testing

- **Quantity** of a specific audit procedures to be performed
- Required judgment
- After consideration of materiality
- Higher Risk = increase extent
- Use sampling approach or not?

# MC – HKSA 315 (Revised 2016)



## T – Timeliness of Substantive Testing

- Perform further audit procedures **at an interim or at period end**
- Perform audit procedures before the period end – to identify significant matters at early stage of audit
- Higher risk = perform sub tests nearer to or at period end

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## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Existence** – Assets, liabilities, and equity interests do not exist at the Balance Sheet Date

#### Examples for increase risk:

- Multi-locations
- Assets held by third parties
- Assets that have special characteristics – require an expert to identify

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Completeness** – All assets, liabilities and equity interests that should have been recorded have not been recorded.

#### Examples for increase risk:

- Multi-locations, assets held by third party
- Wrong posting, off balance sheet items
- Understate of liabilities



# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Accuracy, Valuation and Allocation** – Assets, liabilities, and equity interests are included in the financial statements **at inappropriate amounts** and any resulting valuation or allocation adjustments are not appropriately recorded

#### Examples for increase risk:

- Valuation subject to heavy estimate/ heavy market fluctuations/ expert's valuation / Heavy complex calculation is involved in the valuation i.e. manufactured goods – DM, DL, OH



# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Rights and Obligations** – The entity does not hold or control the rights to assets, and liabilities are not the obligations of the entity

#### Examples to increase risk:

- Subsequent events – title has been passed
- Many different contracts with many different terms
- Title is subject to specific HKAS

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Occurrence** – Transactions and events that have been recorded have not (1) **occurred** nor (2) pertain to the entity.

#### Example to increase risk:

- Sales occurred at year end
- Multiple sales – sales last for several years
- Invoice not with the client
- Consignment sales

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Completeness** – All transactions and events that should have been recorded have not been **recorded**

#### Examples to increase projects:

- Consignment sales
- Cutoff dates different for many companies
- No pre-numbering invoice
- No authorization n sales invoice

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Cutoff** – Transactions and events have been recorded in an **incorrect accounting period**.

#### Examples to increase risk:

- Transactions taken after year end
- Management's cutoff procedures not adequate

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## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Accuracy** – Amounts and other data relating to recorded transactions and events have not been **recorded appropriately**.

#### Examples to increase risk:

- Complex HKAS
- Transactions terms have different interpretations
- Involve overseas accounting standards
- Require expert to interpret



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## Risk of material misstatement at Assertion levels

### Statement of Financial Statements & Income Statement – Assertion Risk

**Classification:** transactions and events have been recorded in the proper accounts

**Presentation:** transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework

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## Significant risks

**Significant risks** are **complex or unusual transactions** that may indicate fraud, or other risks or are unusual in their characteristics. Routine, and non-complex transactions are less likely to give rise to significant risk than unusual transactions.

**Significant risks** are those that require special audit consideration.

**Significant risks are often related to:**

- **Non-routine transactions** are transactions which occur occasionally due to either their size or nature.
- Risks of material misstatement may be greater for matters that require the use of **accounting estimates** which involve a degree of uncertainty.

# MC – HKSA 315 (Revised 2016)



## Scenario thinking:

Which Item?	Which assertions?
PPE	
Intangible Asset	
Inventories	
Receivables	
Contingent Liabilities	
Sales	

# MC – HKSA 315 (Revised 2016)



## Exam Techniques:

1. Which item in the FS affected?
2. Which assertions?
3. If figures are given , use them ie Analytical Procedures
4. Relationship between figures
5. What facts are given in the question?
6. Answer the question risk is low/normal or high?
7. How many marks?

# MC – HKSA 315 (Revised 2016)

## Past Paper Practice – MC Dec 2016 – Qu 5a,b



Mini Limited is a company incorporated in Hong Kong and is a subsidiary of Giant Holdings Company Limited (“Giant”) which is a listed company in France. Mini Limited is the cost centre of Giant in Asia which mainly provides administrative and finance support to Giant’s other subsidiaries in Asia. Mini Limited has only 3 staff including the general manager of the Asia operation, the financial controller and a clerk. The accounting software used by Mini Limited for daily book-keeping is “Easydone” which is a simple packaged software with no customization function. All 3 staff of Mini Limited edit and post access in “Easydone” and they share the same user ID and password. All accounting vouchers are kept in paper format. Both the preparers and reviewer are required to sign on the paper vouchers.



# MC – HKSA 315 (Revised 2016)



## Past Paper Practice – MC Dec 2016 – Qu 5a,b (Cont'd)

### Required:

a) Assume you are the auditor of Mini Limited, identify and explain two likely causes of material misstatements in the financial statements in terms of the segregation of duties and control over system access in relation to the audit of its Hong Kong statutory financial statements.

(4 marks)

b) In respect of the small operation scale of Mini Limited, discuss and explain whether you would adopt a combined testing approach of substantive procedures and tests of controls.

(2 marks)

# MC – HKSA 315 (Revised 2016)



## Past Paper Practice – MC Dec 2016 – Qu 5a,b

### Answer (a)

The risks of material misstatements to the financial statements may include:

#### Lack of segregation of duties

Mini Limited has only 3 staff. Such a lean reporting structure may hinder the company with regards to setting up the proper segregation of duties. There may be a risk that the same person prepares the data, feeds it into the computer, supervises the processing and acts as end user. This lack of division of duties leads to enhanced opportunities for fraud.

#### Lack of control over users

“Easydone” is readily available to all 3 staff of Mini Limited and their access to the system is not well controlled as they share the same user ID and password.

This may increase the opportunity and the risk of accounting records being altered or amended.

# MC – HKSA 315 (Revised 2016)

## Past Paper Practice – MC Dec 2016 – Qu 5a,b (Cont'd)



### Answer (b)

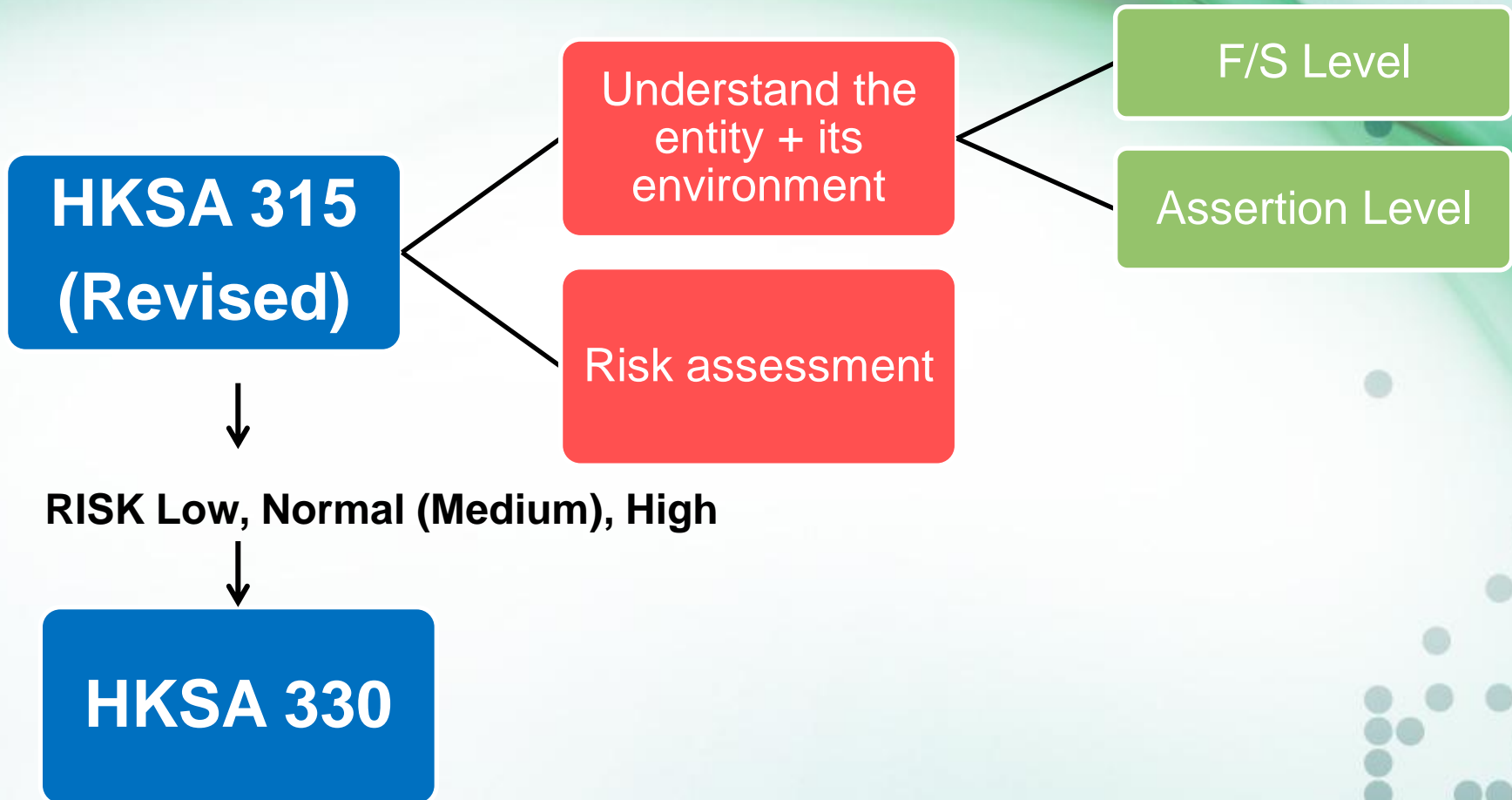
In view of the small scale of operation and lean reporting structure of Mini Limited, it is unlikely that Mini Limited implements sufficient controls to reduce the risks of undetected errors. It may be more cost effective to concentrate the audit work by using substantive procedures rather than analysing the general controls and application controls in details. Auditors may use more extensive physical examination and confirmation of assets, more tests of transactions, larger sample sizes, etc.



# HKSA 330

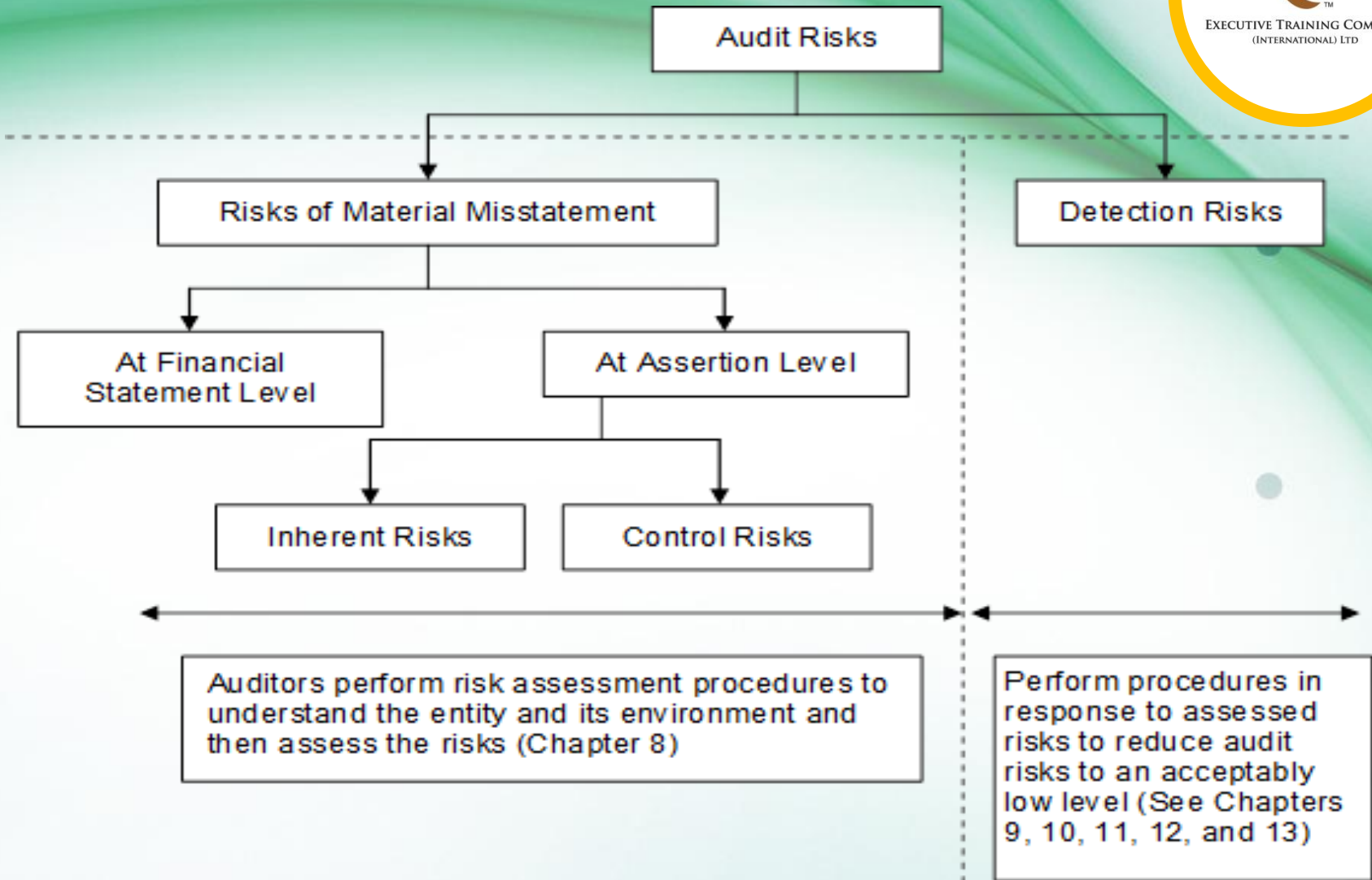
## Responses to assessed risks

# MC - HKSA 330





# MC - HKSA 330



# MC - HKSA 330



## For Financial Statement Level

- Remind the engagement team to maintain professional skepticism
- Assign more experienced staff
- Budget more review and supervision
- Assign an expert if required, for example if computer fraud is suspected
- Do not rely on entity's internal control and use substantive procedures only
- Perform audit procedures in unexpected manner
- Consider resignation from engagement
- Collect more pervasive evidence
- Making general changes to the nature, timing or extent of audit procedures

# MC - HKSA 330

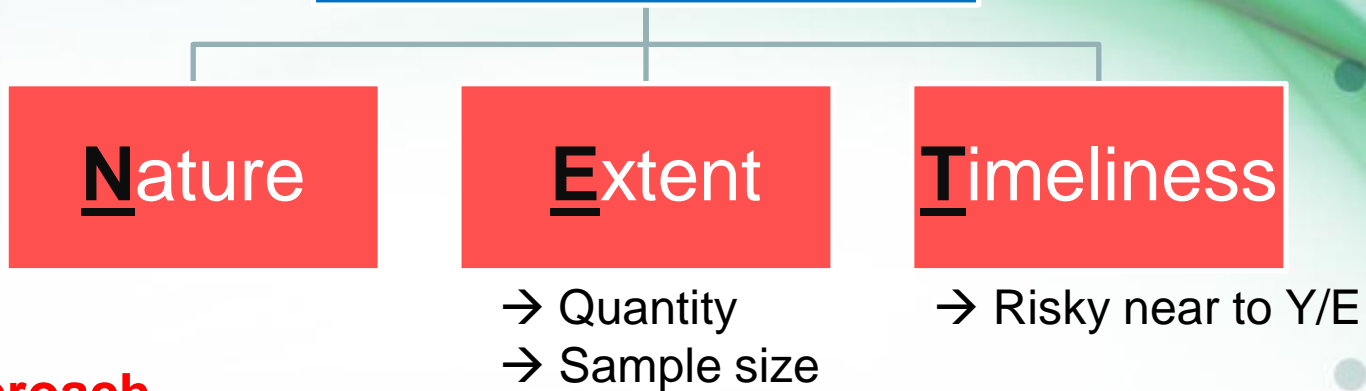
## For Assertion Level



The HKSA 330 says that the auditor shall design and perform appropriate audit procedures whose **nature, extent and timing** are based on and are responsive to the assessed risks of material misstatement at the assertion level.



## Audit Procedures



### Audit Approach

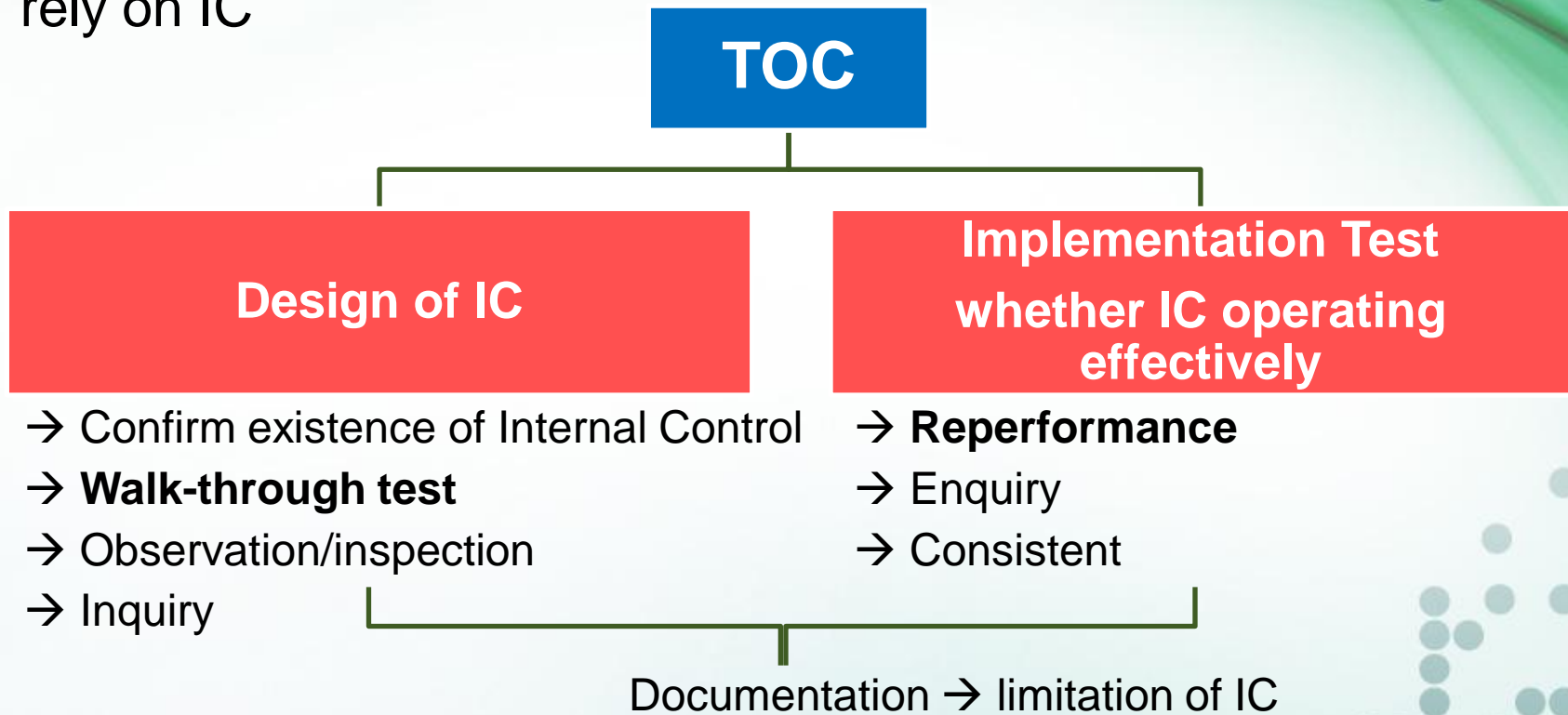
- **Combined** Approach  
→ TOC & Sub Testing: IC strong
- **Substantive** Approach  
→ Substantive Testing only: IC weak

***MUST perform some Substantive Testing***

## Tests of Controls

Purpose:

- reduce Substantive Testing
- rely on IC





## Tests of Controls

WHEN to perform IC → TOC

Expect IC working effectively

- control risk  
→ low
- rely on IC  
→ decrease Substantive Testing

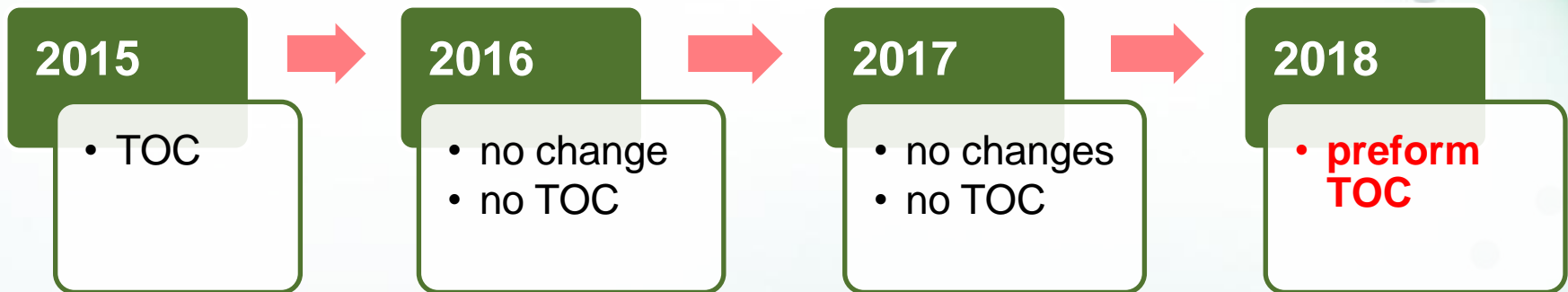
E-business

- Substantive Testing cannot  
satisfy sufficient and  
appropriate audit evidence  
→ TOC

## Tests of Controls

### Rely on TOC from prior year

- **Change** as from last tested
- TOC must be performed **every 3 years** even without changes



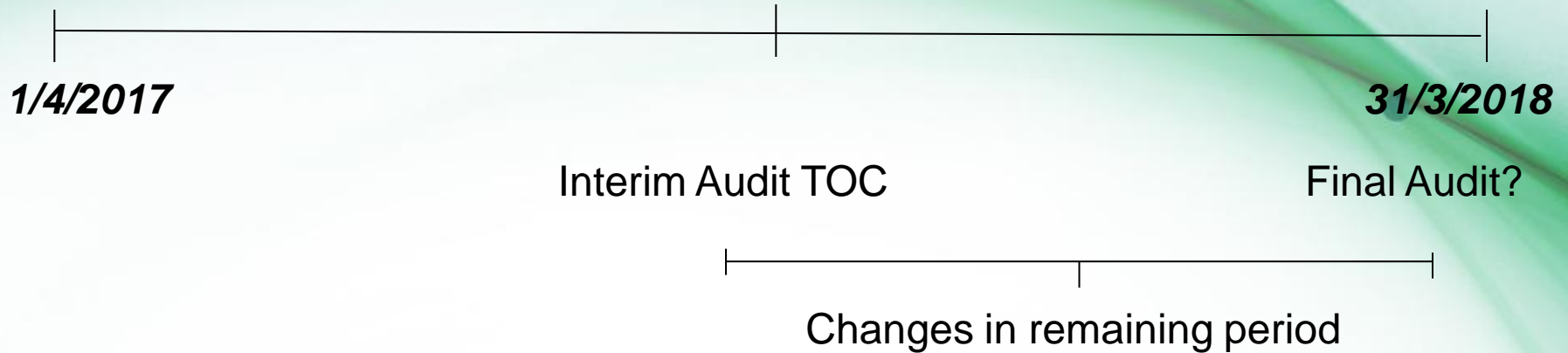


## Tests of Controls

The auditor shall also undertake tests of controls when it will not be possible to obtain sufficient appropriate audit evidence **simply from substantive procedures alone**. This might be the case if the entity conducts its business using IT systems which do not produce documentation of transactions.

# MC - HKSA 330

## Test of Controls

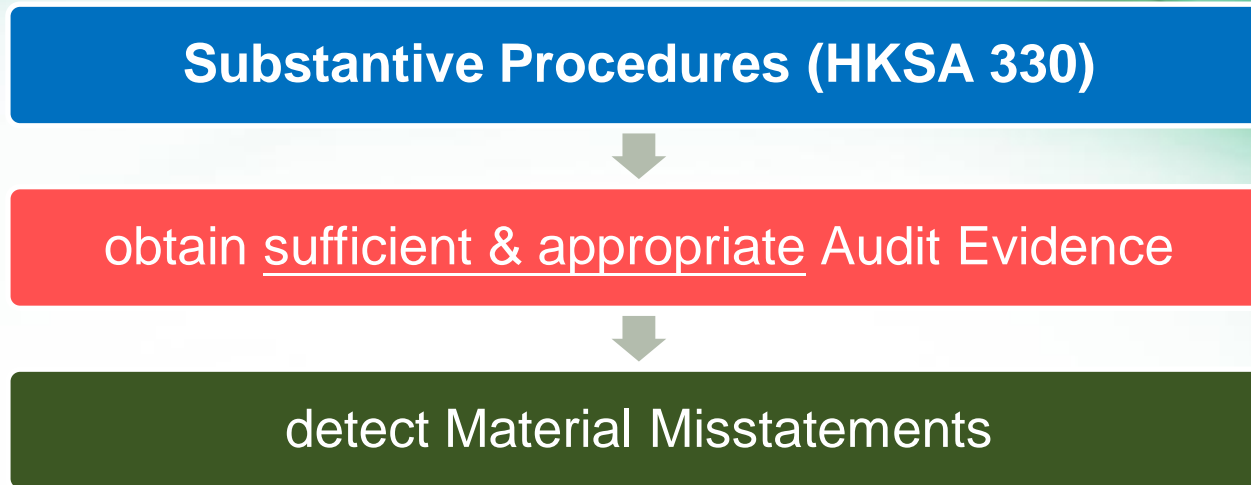


IC to mitigate **significant risks**

→ Auditor must test every year even without changes

# MC - HKSA 330

## Substantive Testing



### WHEN:

- CR high ; IC weak → Substantive Testing ↑
- reduce Detection Risk





### Substantive Testing

#### Substantive Analytical Procedures

- large volume of immaterial balances
- IC strong
- expectation of less immaterial errors

#### Tests of Details

- vouching
- confirmation
- tracing
- observation
- specifically responsive to that risk
- appropriate with regard to matters which have been identified as **significant risks**

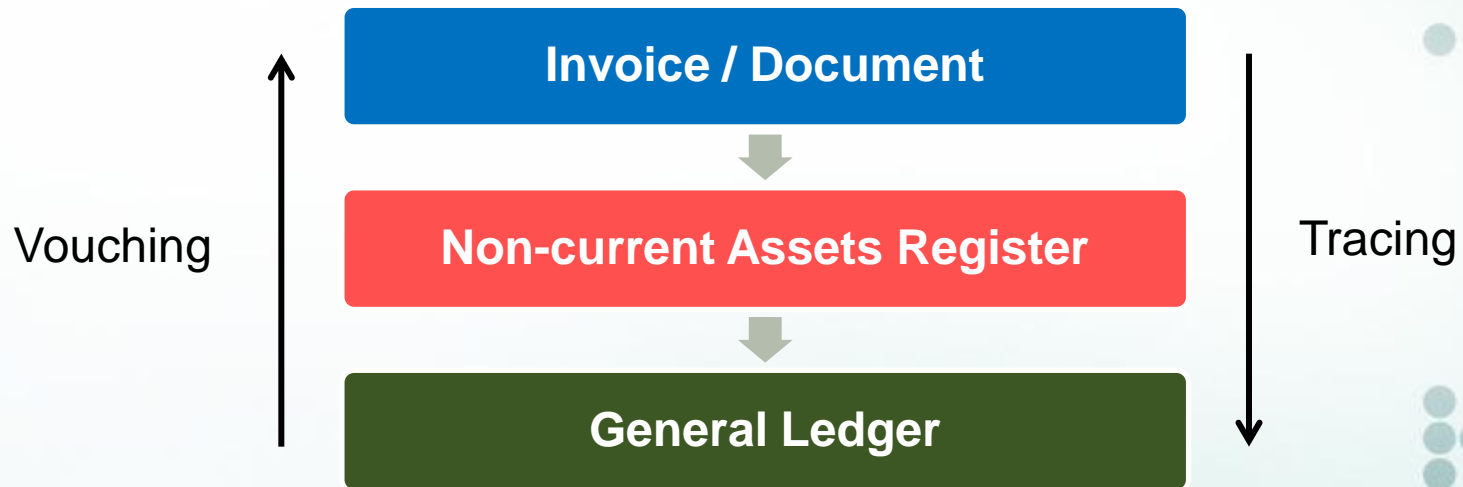
# MC - HKSA 330



## Specific Audit Procedures

### Statement of Financial Position

- Non-current Assets → Fixed Assets
- Property → HKAS 16 *PPE* ; HKAS 40 *Investment Property*
- Plant & Equipment / Computer / MV



# MC - HKSA 330

## Specific Audit Procedures

### For example : Existence

#### **PPE exist properly recorded at Y/E**

- Existence
- PPE recorded in non-current assets register actually exist at Y/E
- Physical inspection
- Confirmation
- Vouch to invoice
- Trace invoice to non-current asset register



# MC - HKSA 330



## Audit Procedures

For example : Completeness: records complete

Bal b/f	xxx	→ <b>Check opening balance</b>
Additions	xxx	→ <b>Check authorization</b>
Disposals	<u>(xxx)</u>	→ <b>BOD minutes, sales &amp; purchase agreements</b>
Bal c/f	xxx	

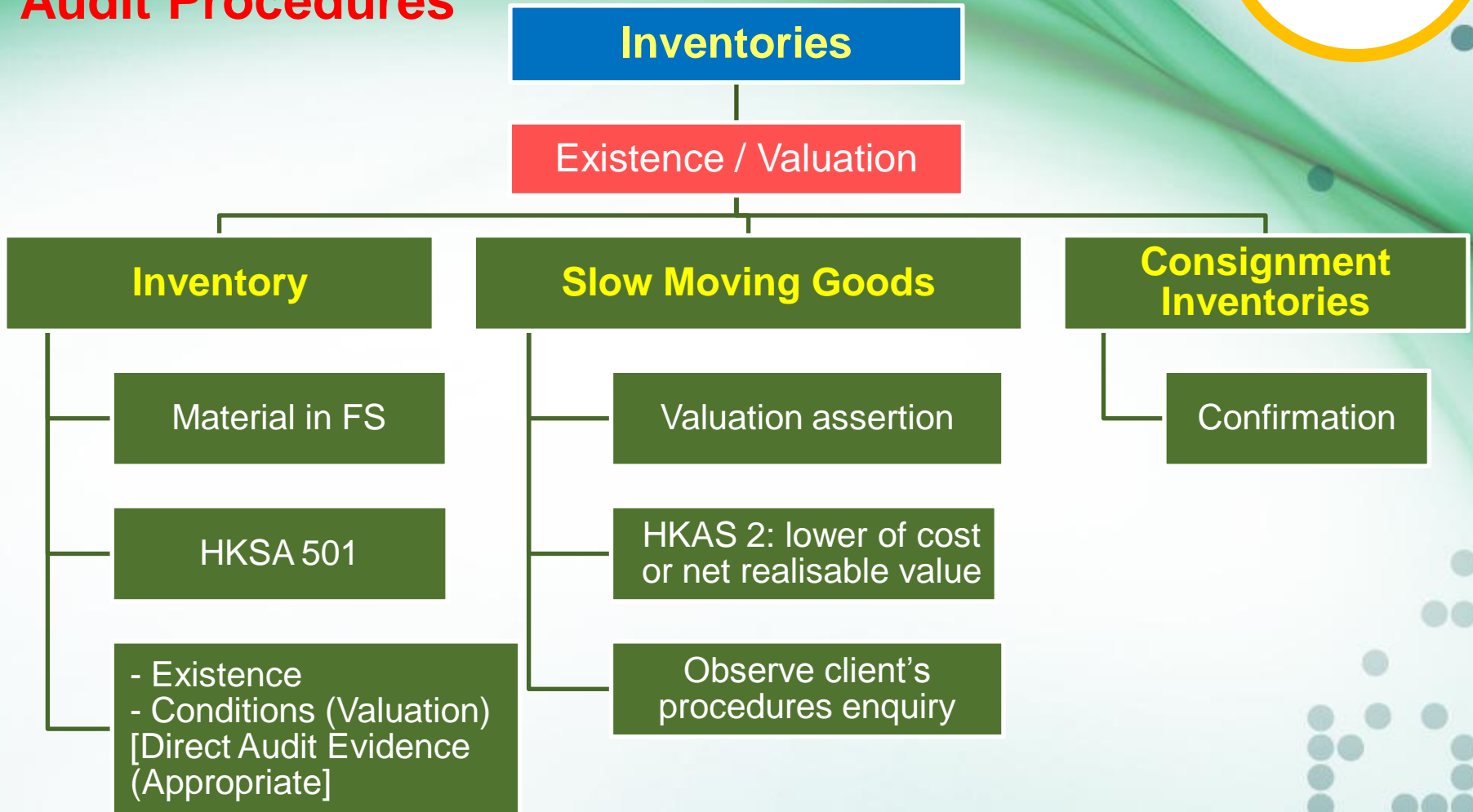
### **PPE exist property recorded at Y/E**

- recalculate P&L on disposal
- check subsequent events
- check cutoff
- perform land search
- vouch to invoice



# MC - HKSA 330

## Audit Procedures







### Accounts Receivable [Debtors]

- Directional Testing → double entry: **(Dr) Trade Debtor**  
**(Cr) Sales**

**HKSA 505 (Clarified) External Confirmation → Direct Communication to External Party**

- **“appropriate”** audit evidence → reliable
- immediately after Y/E
- **maintain control by auditors**
- ie Independent Selection:  
Debtor → directly reply to auditor

**overstate Revenue**  
→ **overstate Trade Debtors**

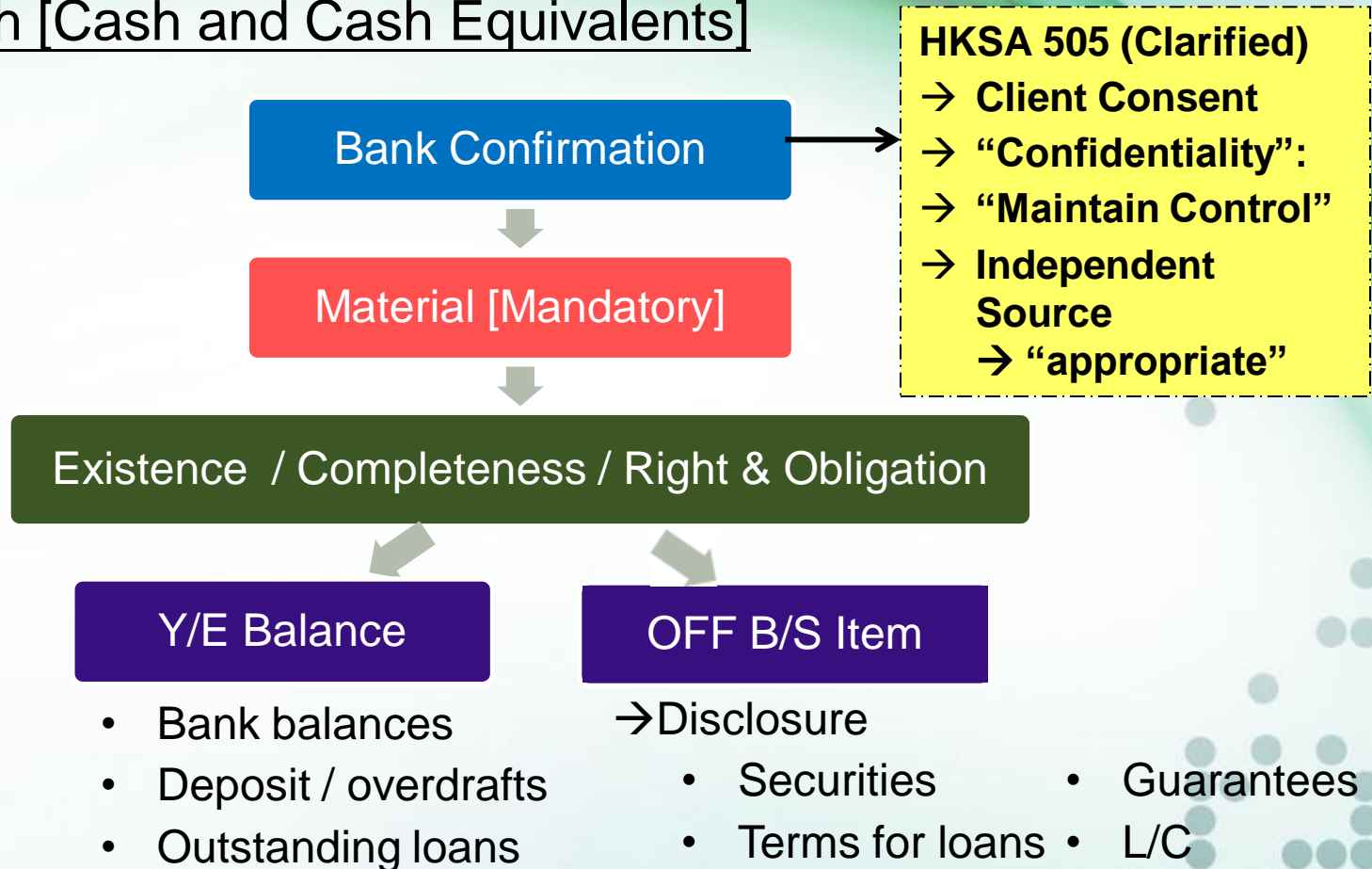
#### Alternative Procedures

- Subsequent Settlement
- Enquiry / Reconciliation

# MC - HKSA 330

## Audit Procedures

### Bank & Cash [Cash and Cash Equivalents]



# MC - HKSA 330

## Audit Procedures

Sales [Revenue]

Large volume of transactions

Material

(1) Substantive Analytical Procedures

- Compare with last year %↑ risk ↑
- Ratio Gross Profit Margin [Turnover convert into profits]
- Compare Trade Receivable [Liquidity Position]
- Compare to Inventory [ability to sell existing inventories]



# MC - HKSA 330

## Audit Procedures

Sales [Revenue]

Large volume of transactions

Material

(2) Tests of Details

- **Occurrence:** vouch to sales invoice / order
- **Completeness:** tracing dispatch notes to sales ledger
- **Accuracy:** Sales Recognition Policy
- **Cutoff:** Cutoff Procedures
- **Accuracy Presentation:** discounts





## Past Paper Practice – MC Dec 2016 – 7a,b

Rent Smart Limited (“R Smart”) is a leading service company in Hong Kong providing portable sanitation equipment and cleaning services. It supplies portable restrooms which are widely used at construction sites, special events or corporate functions. You are the audit engagement senior and are new to the audit engagement of R Smart. You have been asked by your audit engagement manager to plan the year end audit procedures for the fixed assets of R Smart. You studied the prior year’s audit work papers and inquired the finance manager of R Smart. Your findings are summarised below:

- Over 70% of R Smart’s total assets are sanitation equipment.



# MC - HKSA 330



## Past Paper Practice – MC Dec 2016 – 7a,b (Cont'd)

- R Smart's sanitation equipment (i.e. over 300 portable restrooms and pumping systems) are all rented out most of the time. These items of sanitation equipment are usually held at the customers' premises and R Smart keeps a good record of the locations of these items of sanitation equipment.
- R Smart has been very profitable and received very good comments from its customers on service quality.
- R Smart's office and warehouse are located in the New Territories. R Smart has a team responsible for equipment cleaning and maintenance.

# MC - HKSA 330



## Past Paper Practice – MC Dec 2016 – 7a,b (Cont'd)

- During the year, the management of R Smart considered the increasing demand of the toiletry service and purchased 100 more portable restrooms and spent a significant amount on 100 existing portable restrooms to improve their facilities and design.
- Since most parts of the sanitation equipment are very durable, R Smart adopts a depreciation policy that is comparable to other industry players. The sanitation equipment is depreciated over 10 years.

# MC - HKSA 330



## Past Paper Practice – MC Dec 2016 – 7a,b (Cont'd)

### Required:

In response to the facts given above,

a) Assess the risks of material misstatements of fixed assets in terms of the existence and valuation assertions and explain your views.

(4 marks)

b) Propose the relevant audit procedures in response to the risks identified in Question 7(a) over the existence assertion.

(2 marks)

# MC - HKSA 330



## Past Paper Practice – MC Dec 2016 – 7a,b (Cont'd)

### Answer (a)

The risk of material misstatement of fixed assets in terms of existence is high. This is because:

- The carrying value of sanitation equipment represented a significant balance of the company's total assets.
- The amount of new additions of fixed assets during the year is large.

The risk of material misstatement of fixed assets in terms of valuation is low. This is because the company has been profitable and its sanitation equipment is rented to customers most of the time during the year which indicates the fixed asset impairment risk is low. The company's depreciation policy seems to be reasonable as it adopts a depreciation policy which is comparable to other industry players.



## Past Paper Practice – MC Dec 2016 – 7a,b (Cont'd)

### Answer (b)

In response to the risk of material misstatement of fixed assets in terms of existence assertion identified in Question 7(a), the relevant audit procedures should include the following:

- Ask the management to confirm whether they have physically inspected all the sanitation equipment in the fixed asset register each year.
- Review the management's physical count instructions and manual and year-end plan on the physical count.
- Obtain the fixed asset register from the management and reconcile the opening and closing asset by numbers and amounts.
- Perform a physical inspection of the sanitation equipment (i.e. portable restrooms, pumping system) on a selected basis.



# MC - HKSA 330



## Past Paper Practice – MC Dec 2016 – 7a,b (Cont'd)

### Answer (b) (Cont'd)

- Inspect the items to ensure the inspected items do exist, are in use and good condition and have the correct serial numbers.
- Understand the management's processes and controls over the fixed asset recognition process.
- Evaluate the design of the management's controls over fixed asset recognition process.
- Validate the key controls of the fixed asset recognition process, if any.
- Test the current year's fixed assets additions by inspecting the supporting documents such as supplier invoices and delivery notes.
- Arrange to obtain from third parties confirmations of the sanitation equipment they hold.

# MC - HKSA 330

## Past Paper Practice – MC Jun 2016 – 5



Super Store Limited (“Super”) is a mini store selling household accessories. As at 31 December 2015 and 2014, Super had the following key trade payables:

<u>Name of suppliers</u>	<u>Nature of balance</u>	2015 Amount HK\$	2014 Amount HK\$
Supplier A	Accessories supply	20,000	25,000
Supplier B	Accessories supply	30,000	35,000
Supplier C	Accessories supply	-	50,000
Supplier D	Accessories supply	35,000	-
Supplier E	Construction	13,000	13,000
Other suppliers with balance less than HK\$1,000 each		30,000	35,000
Total		<u>128,000</u>	<u>158,000</u>



## Past Paper Practice – MC Jun 2016 – 5 (Cont'd)

You are the auditor of Super for auditing its financial statements for the year ended 31 December 2015. You have conducted the audit planning of Super and considered that the risk of material misstatement in completeness of trade payables is high. Your audit strategy on trade payables is not to rely on internal control.

### Required:

**Propose substantive audit procedures to test the completeness of trade payables.**

**(12 marks)**



## Past Paper Practice – MC Jun 2016 – 5 (Cont'd)

### Answer

The substantive audit procedures to test the completeness of trade payables include the following:

- From the listing of trade payables, reconcile the total amount of HK\$128,000 with the general ledger by casting and cross-casting.
- Select samples of suppliers' statements and trace these back to the suppliers' accounts.
- Consider whether there could be significant unrecorded liabilities by making inquiries of the management.
- Ask the management about balances with significant fluctuations, such as the balance with Supplier C which had decreased from the previous year from HK\$50,000 to zero at the current year end.



# MC - HKSA 330



## Past Paper Practice – MC Jun 2016 – 5 (Cont'd)

### Answer

- Ask the management about unusual items, such as the balance due to Supplier E, which is construction in nature and is not related to Super's business.
- Examine files of unmatched purchase orders and supplier invoices for any unrecorded liabilities.
- Examine post year-end transactions and subsequent payments and compare the actual dates with the dates they were recorded in the ledger to check whether the cut-off has been applied correctly.
- Confirm the balances with Suppliers A, B, D and E, and the balance with Supplier C (zero balance) and a few suppliers with balances less than HK\$1,000.



# MC - HKSA 330

## Past Paper Practice – MC Jun 2016 – 5 (Cont'd)



### Answer

- Perform confirmations of trade payables. Perform follow-up procedures for those confirmations which disagree with the information in the request and confirmations without a reply.
- As the risk on completeness of trade payables is “high”, there may be a risk of unrecorded liabilities. Regular suppliers who have small or zero balances on their accounts and a sample of other accounts will be confirmed in addition to any large balances.
- Perform comparisons on the following data to check for reasonableness:
  - Current year balances for trade payables and accruals with the previous year.
  - The amounts owed to a sample of individual suppliers in the trade payables listing to amounts owed to these suppliers in the previous year.
  - The payables’ turnover and payables’ days with the previous year and industry data.
- Complete the disclosure checklist to ensure that all the disclosures relevant to liabilities have been made.

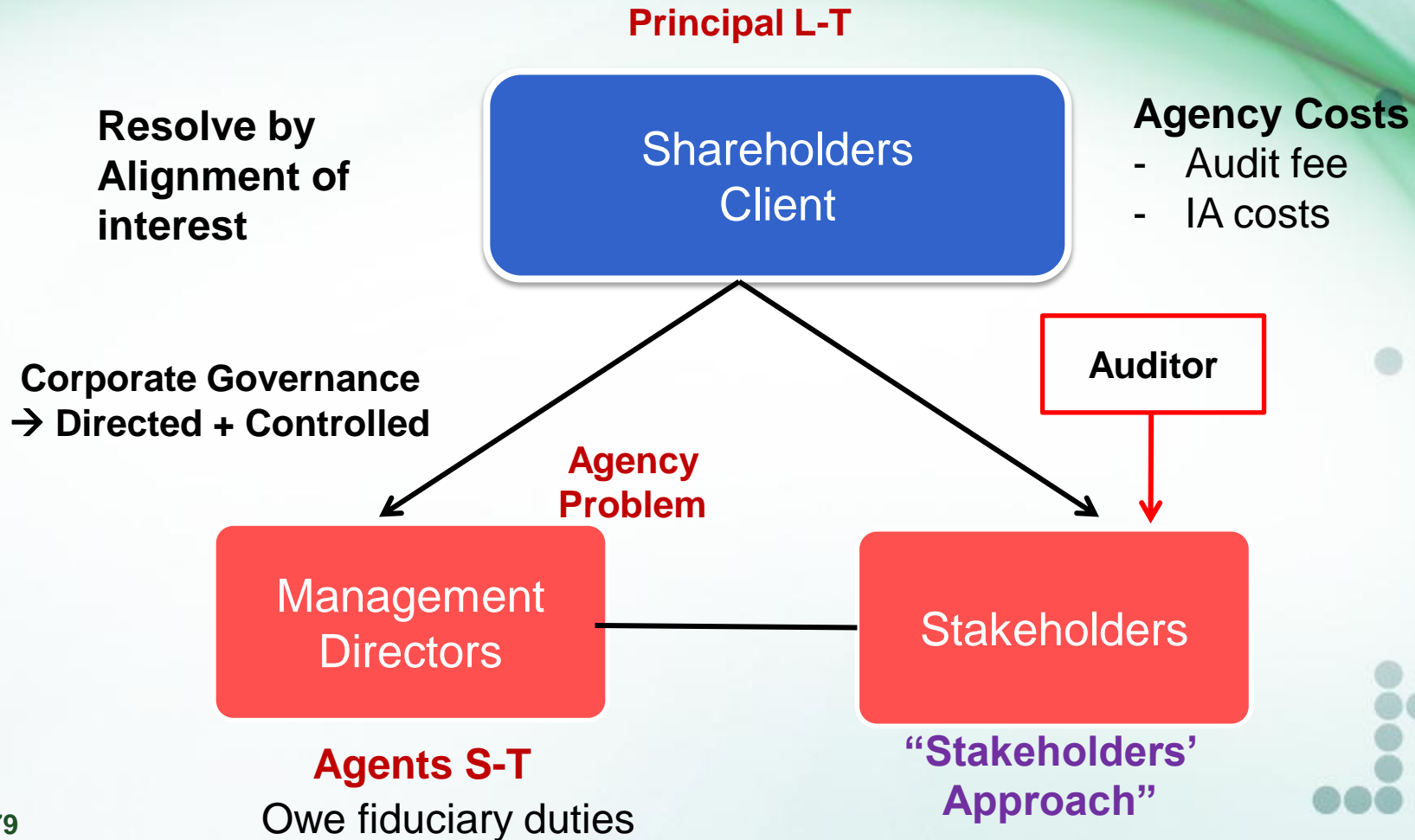


# Corporate governance code and corporate governance report

# MC - Corporate governance code and corporate governance report



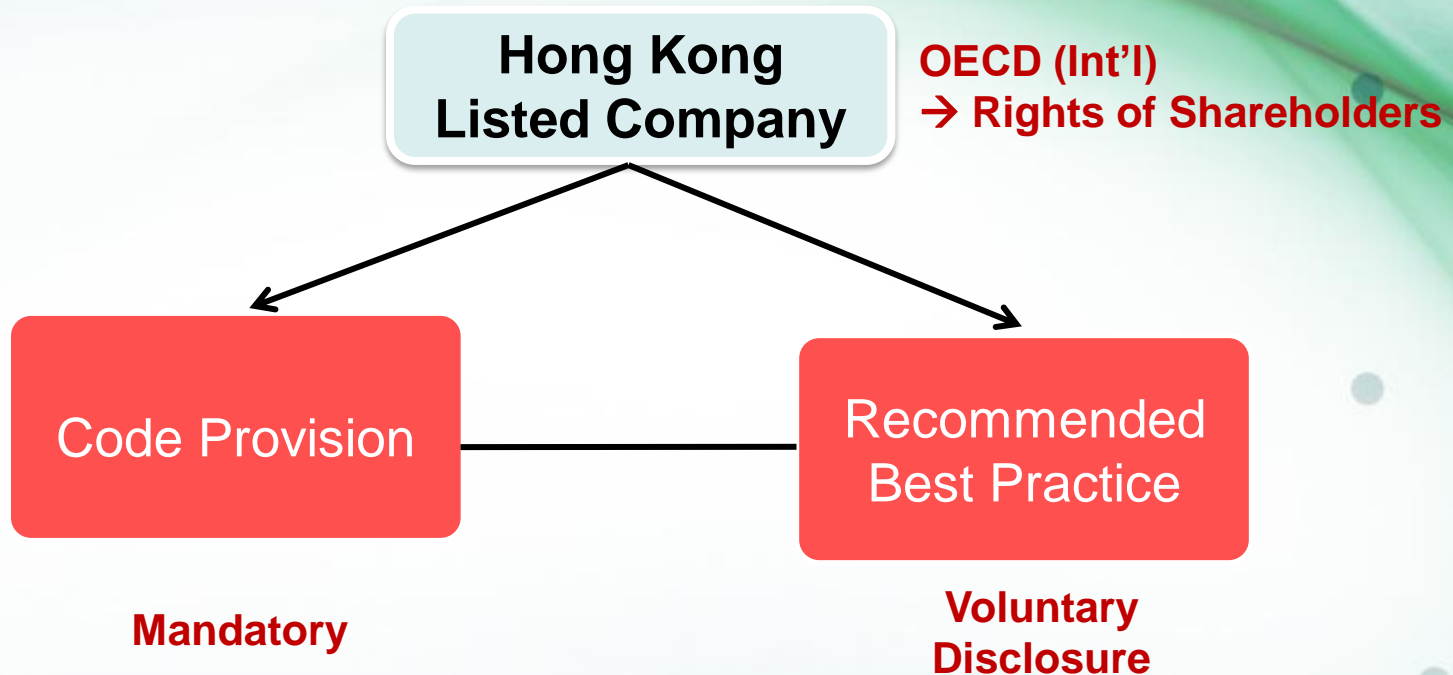
## Why Corporate Governance?



# MC - Corporate governance code and corporate governance report



## Hong Kong Listed Companies



**Comply or Explain approach –**

Non-Compliance : disclose in annual report

# MC - Corporate governance code and corporate governance report



## Exam Technique

1. Criticize Problem

2. Recommendations

3. Follow Listing Rules

**Company with problems**



# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts I

- **The Board** – effective board / **active interest in the issuer's affairs**
- **Chairman and Chief Executive Officer** – separated a clear division of these responsibilities at the board level.
- **Board composition** – balance of skills and experience appropriate; The new Rule required that at least **one-third** of an issuer's board should be **independent non-executive directors (INEDs)**.

# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts I

- **Appointments, re-election and removal** – formal, considered and transparent procedure for the appointment of new directors to the board.
- **List of directors should be published on the issuer's website**

# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts II

- **An INED who has served nine years**
- **Separate resolution to retain an INED who has served on the board for more than nine years.**
- **Directors should provide records of training they received to issuers.**
- **Board should regularly review the contribution by a director.**

# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts II

- **Supply of and access to information** – Directors should be provided in a timely manner with appropriate information.
- The board should be **responsible** for corporate governance.
- Non-executive directors, including INEDs, should attend board, committee and general meetings and contribute to the issuer's strategy and policies.

# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts III

- **Directors – Remuneration of directors and senior management and Board Evaluation**
- Disclose information relating to its **directors' remuneration policy** and other remuneration related matters. ( Disclosed in full in the annual reports and Accounts)
- The company should establish a **remuneration committee**
- **Formal and transparent procedure** for setting policy on executive directors' remuneration



# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts III (Cont'd)

- Fixing the **remuneration packages** for all directors
- A significant proportion of executive directors' remuneration should be structured so as to **link rewards** to corporate and individual performance.
- Directors' fees and any other **reimbursement or emolument payable to a director must be disclosed in full in the annual reports and accounts** of the issuer on an individual and named basis.
- Basic salary + ST and LT bonus + Share Awards and Share options

# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts IV

- **Audit Committee** – The board should establish **formal and transparent arrangements** for considering how it will apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.
- Listed company should establish a **shareholder communication policy**.

# MC - Corporate governance code and corporate governance report



## Corporate Governance Concepts IV

- **Company Secretary**
- The Company Secretary supports the Chairman in **promoting** the highest standards of corporate governance.
- **Ensuring good information flow** within the board and that board policy and procedures are followed.
- The Company Secretary **reports to the Chairman**

## Auditor attending the AGM

# MC - Corporate governance code and corporate governance report



## Corporate Governance

## The New Hong Kong Companies Ordinance

**The new CO Commenced operation from 3 March 2014.**

Under the new CO, there are new measures for enhancing corporate governance and the following are some of the major measures for the enhancement :

# MC - Corporate governance code and corporate governance report



## Corporate Governance

### a) Strengthening the accountability of directors

Restricting the appointment of corporate directors by requiring every private company to have **at least one natural person** to act as director, to enhance transparency and accountability.

### b) Enhancing shareholder engagement in the decision-making process

### c) Improving the disclosure of company information

Requiring public companies and the larger (ie companies that do not qualify for simplified reporting) private companies and guarantee companies to **prepare a more comprehensive directors' report**

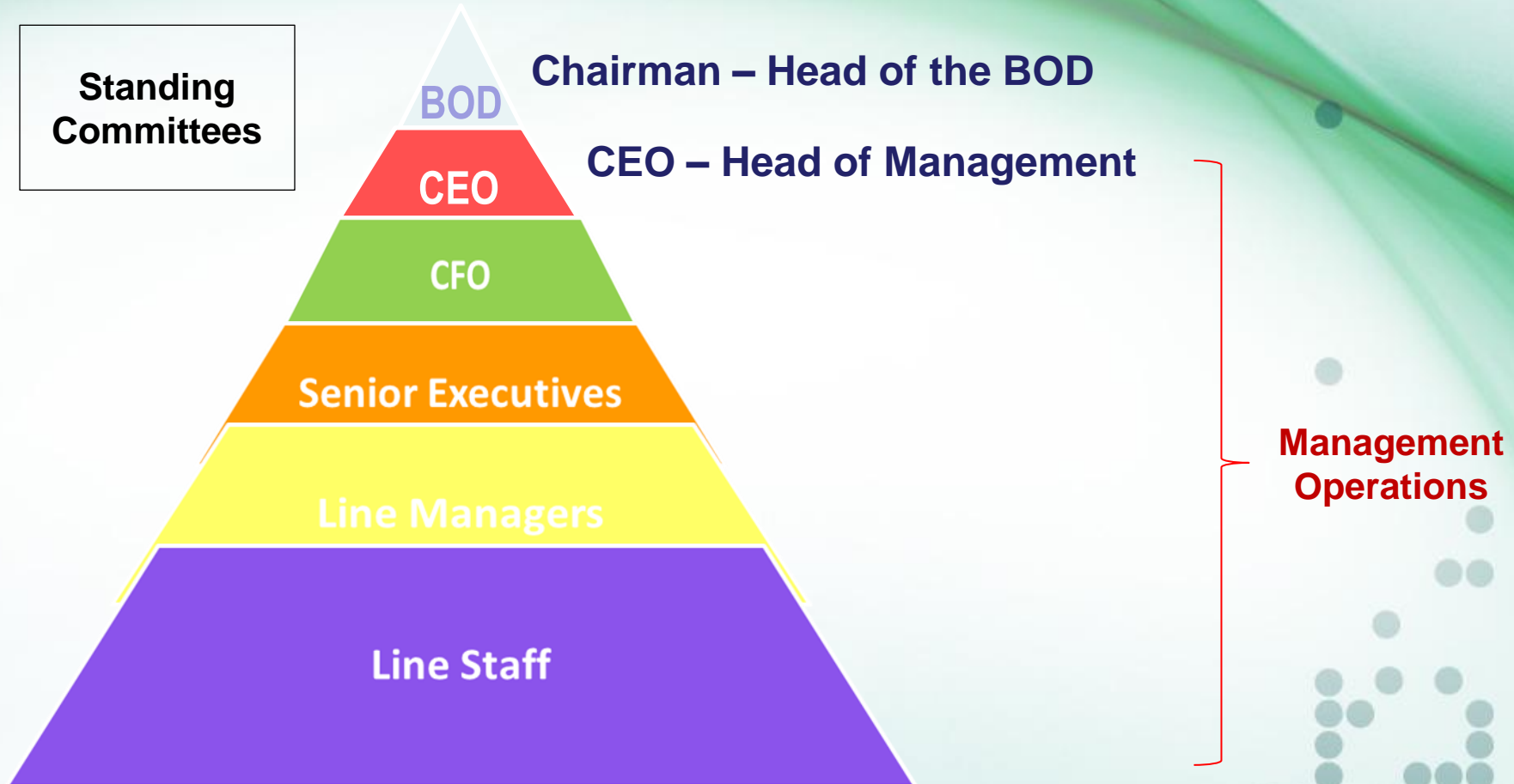


# MC - Corporate governance code and corporate governance report



## Chairman Vs CEO

*“Chairman ≠ CEO”*



# MC - Corporate governance code and corporate governance report



## Chairman's Role

- leader of the board of directors in a private or public company
- responsible for ensuring the board's effectiveness
- setting the board's agenda and ensuring that board meetings take place
- “public face” of the organisation
- communication with shareholders.
- co-ordinating the contributions of non-executive directors (NEDs) and facilitating good relationships between executive and non-executive directors.

# MC - Corporate governance code and corporate governance report



## Standing Committees

### Nomination Committee

- NEDs - majority of INEDs
- Nominate directors
- Recommendation to BOD

### Remuneration Committee

- NEDs
- Remuneration policy
- Remuneration procedures

### Audit Committee

- NEDs
- Deal with external auditors
- Formal transparent appointment of auditors

### Risk Committee

- EDs and NEDs
- Risk policies
- Risk responses

# MC - Corporate governance code and corporate governance report



## The Board

### EDs

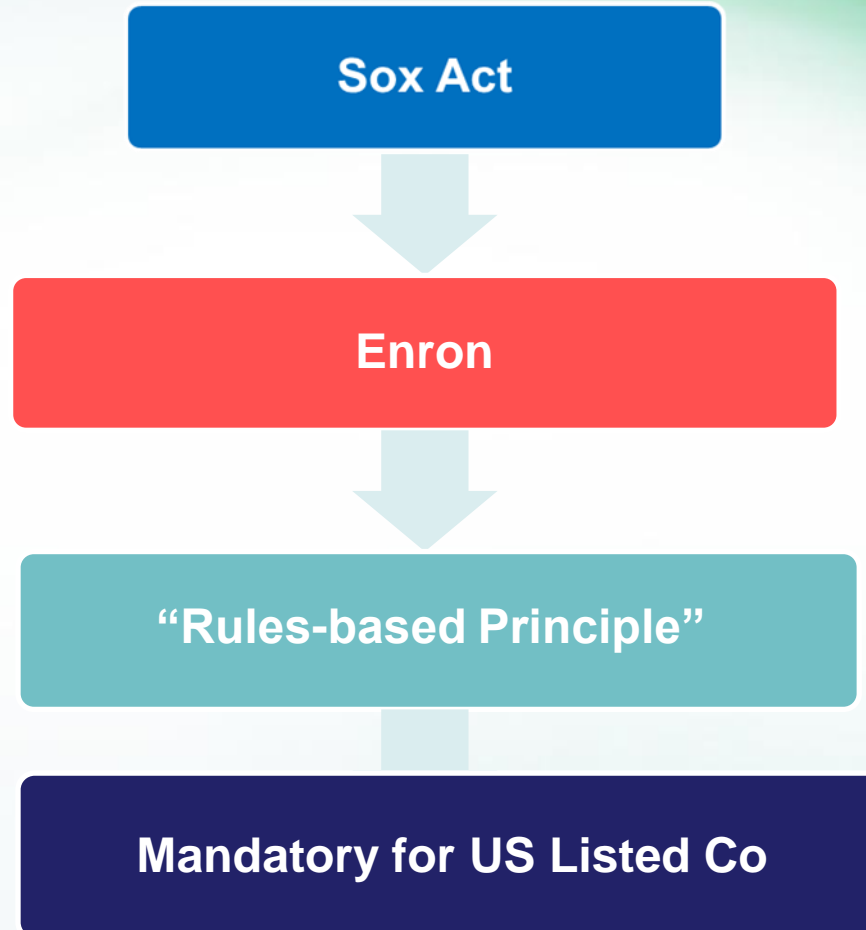
- Implement strategies
- Setting strategies
- Implementing internal controls
- Monitor controls

### NEDs

- Review / Monitor / Recommendation to BOD
- Board Committee
  - Nomination
  - Remuneration
  - Audit
  - Risk
  - Fixed fee
  - No performance related pay  
ie bonus or share options

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## Sarbanes - Oxley Act 2002





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## Major Concepts in SOX

- New Regulator → Public Oversight Board (“PCAOB”)
- Regulate Audit Firms
  - Retain working papers 7 years
  - Prohibit other non audit services
  - Rotate Partner every 5 years
  - Audit Committee **(MUST)**
- CEO + CFO – certify FS – forfeit their bonuses
- Disclose off-balance sheet item
- Adequate IC reporting
- Whistle blowing

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2017 – Qu 9

Company E is a listed company in Hong Kong principally engaging in construction and property development. Company E currently has a Board of Directors (“Board”) consisting of five executive directors including the Chairman of the Board and three independent non-executive directors. Company E also has an audit committee consisting of three independent non-executive directors. Since one of the independent non-executive directors has served Company E for over nine years, he would like to retire from the company as the independent non-executive director and the Chairman of the audit committee. The Board of Company E proposes to accept his retirement request and appoint the Chairman of the Board to be the Chairman of the audit committee.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2017 – Qu 9(Cont'd)

### Required:

- a) Identify the difference(s) between independent non-executive directors and executive directors.  
(2 marks)
- b) Explain why the independence of independent non-executive directors can promote corporate governance.  
(2 marks)
- c) Determine the possible corporate governance issues under the Hong Kong Listing Rules in view of the proposed change of the Board and the audit committee composition presented above and propose solutions.  
(5 marks)

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2017 – Qu 9(Cont'd)

### Answer (a)

Independent non-executive directors do not have day-to-day operational responsibility for the company while the executive directors do. Non-executive directors are not employees of the company or affiliated with it in any other way while the executive directors are.



# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2017 – Qu 9(Cont'd)

### Answer (b)

Independence is an important concept in relation to a director. Directors who are not primarily employed by the company should be free from conflicts of interest and in a better position to promote the interest of shareholders and other stakeholders. Independent non-executive directors are free from pressure that could influence their activities and should be able to carry out effective monitoring of the company on behalf of the shareholders. In addition, independent non-executive directors' lack of links in the company and limits on the time that they serve as independent non-executive directors should promote the avoidance of accepting the executive management's view or trust without analysing and questioning them.





# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2017 – Qu 9(Cont'd)

### Answer (c)

Under the Hong Kong Listing Rules, at least one-third of a listed company's board should be independent non-executive directors ("INED"). With the retirement of one of the INEDs, there will only be two INEDs with Company E which will be below the "one-third" requirement.

In addition, the Hong Kong Listing Rules also require an audit committee consisting entirely of non-executive directors and there should be at least three members on the committee. The Chairman of the audit committee must be an INED. By appointing the Chairman of the Board as the Chairman of the audit committee, Company E fails to meet the Hong Kong Listing Rules on audit committee composition.

Company E should either appoint another INED or recommend that shareholders should vote on a separate resolution to retain the INED who has served Company E for more than nine years. Company E should include the reasons why the Board considers the INED is independent in the circular nominating him for election.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6

The Code on Corporate Governance Practices (the “HK Code”) published by the Hong Kong Stock Exchange contains a combination of broad principles, specific code provisions and recommended best practices.

Company A is a garment manufacturing company and plans for an initial public offering (“IPO”) in the coming year. Company A is primarily owned by Mr Lee and Mr Chung who are the Chairman and Chief Executive Director (“CEO”) of Company A respectively. You are the auditor of Company A. During the audit planning meeting, Mr Lee and Mr Chung seek your advice as to how Company A should comply with the HK Code to prepare Company A to be listed on the Hong Kong Stock Exchange.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

Company A's board of directors consists of seven members including Mr Lee, Mr Chung and one independent non-executive director that meets on a regular basis to discuss key business matters. Company A's board of directors consists of members who have extensive experience in the textiles industry and strong finance backgrounds.

Company A has an internal audit team but has yet to set up any audit committee or any other committees to support the board. The head of the internal audit team reports directly to Mr Lee. Company A's company secretary is a third party service provider who provides Mr Lee and Mr Chung with the latest corporate governance information on a regular basis.

The prior year audit evidenced that Company A has set a good practice at the top and introduced a clear business code of conduct to all of its employees. The tests of controls also indicated that Company A's key controls over financial reporting were effective.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

### Required:

- a) Explain the current approach required by the Hong Kong Stock Exchange for a listed company in Hong Kong when applying the HK Code.  
(2 marks)
- b) Identify elements which indicate that Company A is in compliance with the HK Code.  
(4 marks)
- c) Recommend how Company A can improve its corporate governance for the preparation of the IPO.  
(4 marks)



# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

### Answer (a)

The listed companies in Hong Kong are required to adopt the “comply or explain” approach to the HK Code. They are required to confirm their compliance with the HK Code or, where they do not comply, to provide explanations for any variation in practice.



# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

### Answer (b)

The following indicates that Company A is in compliance with the HK Code:

- Company A has a balanced board of directors which is evidenced by the following:
  - Company A's board of directors consists of different members who have relevant expertise and experience in the garment manufacturing / textiles industry. The board also consists of members who have expertise in finance.
  - Company A's board of directors also meets regularly to discuss key business matters.
  - Company A's Chairman and CEO are different persons. Mr Lee and Mr Chung are the Chairman and CEO of Company A respectively so they can balance the power of each other in the board.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

### Answer (b) (Cont'd)

- Company A maintains a sound system of internal control to safeguard shareholder's investment and the company's assets which is evidenced by the following:
  - Company A has an internal audit team, with good practice at the top and clear business code of conduct to employees.
  - The prior year audit also indicated that Company A's key controls over financial reporting were effective.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

### Answer (c)

The recommendations should include:

- At least one-third of an issuer's board should be independent non-executive directors. Company A has only one independent non-executive director out of seven board of directors. Company A should consider increasing the number of independent non-executive directors in the composition of the board.
- Company A should set up an audit committee, nomination committee and a remuneration committee which consist of independent non-executive directors.

# MC - Corporate governance code and corporate governance report



## Past Paper Practice – MC Dec 2016 – Qu 6 (Cont'd)

### Answer (c) (Cont'd)

- Company A's internal audit team should report to the audit committee but not report to Mr Lee directly.
- Company A should hire an in-house company secretary who has day-to-day knowledge of Company A's affairs but not out-source the company secretary's role to a third party service provider.
- The company secretary should provide advice to the board on board procedures and ensure the board follows applicable law, rules and regulations. The company secretary should not just report to Mr Lee and Mr Chung.

# MC Exam Skills



1. Identify audit issues in the case
2. Count the marks
3. Use auditing wordings
4. Writing skills
5. Cross over standards
6. Practical audit procedures
7. Time management