

AGENDA



- Change in Auditor
- Quality Control
- Responses to assessed risk

CHANGE IN AUDITOR



Code of Ethics

- Section 210
- Section 440
- Section 441

CHANGE IN AUDITOR



Section 210 of Code of Ethics

The auditor should consider whether acceptance of the client's audit nomination would create any threats to compliance with the fundamental principles.

CHANGE IN AUDITOR



Section 440 of Code of Ethics

A proposed nominee should

- find out whether the change of auditor has been properly dealt with in accordance with the Companies Ordinance or other legislations; and
 - conduct professional clearance procedures before accepting the nomination.
- With the permission of the prospective client, the proposed nominee should write to the last appointed auditor and ask if there are any unusual circumstances of which the proposed nominee should be aware before accepting the nomination.

CHANGE IN AUDITOR



Section 440 of Code of Ethics

The last appointed auditors should advise the proposed nominee immediately if

- there is any professional or other reason of which the proposed nominee should be aware
- the circumstances surrounding the proposed change
- disclose fully all information needed by the proposed nominee to enable him to make decision in respect of accepting the nomination
- they have suspicions of unlawful acts by directors which have not yet been proved and any matters that ought to be investigated.

CHANGE IN AUDITOR



Section 440 of Code of Ethics

If the replacement of the last appointed auditor is prompted by disagreement over matters such as the truth and fairness of the entity's financial statements or the selection of accounting policies or methods used in auditing, the proposed nominee should obtain the full views of the last appointed auditors.

The proposed nominee should discuss with the entity the areas of disagreement.

CHANGE IN AUDITOR



Section 441 of Code of Ethics – (Listed entity)

- If there are any disagreements between auditors and the client, the issues should be raised with the audit committee so that the committee may help to resolve the issues with management and to complete the audit.
- The last appointed auditor should write a letter of resignation/termination to the audit committee and the board of directors in the event of the resignation or refusing re-appointment, which lists any disagreements or unresolved issues relating to the audit.

CHANGE IN AUDITOR



Section 441 of Code of Ethics – (Listed entity)

- The proposed nominee should request a copy of the letter of resignation/termination and any correspondence from the listed entity.
- If the entity refuses to send the proposed nominee the letter of resignation/termination, the proposed nominee can only decline to accept nomination.
- The last appointed auditor should remind the listed entity of its obligation under the Listing Rules and should ensure the letter of resignation/termination has been brought to the attention of the shareholders. Any disputes should be reported to the audit committee.

CHANGE IN AUDITOR



New Companies Ordinance

See pages 191 to 198 of Learning Pack 5th Edition

QUALITY CONTROL



HKSQC 1

Deals with a firm's responsibilities for its system of quality control for audits and reviews of financial statements, and other assurance and related services engagements.

HKSA 220

Deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements.

QUALITY CONTROL



HKSQC 1

1. **Leadership**
2. **Ethical requirements**
3. **Client Acceptance and continuance**
4. **Human Resources**
5. **Engagement Performance**
6. **Monitoring**

QUALITY CONTROL



1. Leadership

HKSQC 1

- The firm shall establish policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements.
- Such policies and procedures shall require the firm's chief executive officer or, if appropriate, the firm's managing board of partners to assume ultimate responsibility for the firm's system of quality control.

HKSA 220

- The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

QUALITY CONTROL



2. Ethical requirements

HKSQC 1

- The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.
- E.g. Requiring, for audits of financial statements of listed entities, the rotation of the engagement partner and the individuals responsible for engagement quality control review.
- At least annually, the firm shall obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant ethical requirements.

QUALITY CONTROL



2. Ethical requirements

HKSA 220 - *Ethical requirements with regards to independence*

The engagement partner shall:

- Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches to determine whether they create a threat to independence for the audit engagement;
- Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards

QUALITY CONTROL



3. Client acceptance

HKSQC 1

The firm shall establish policies and procedures for the acceptance and continuance of client relationships. It should only undertake or continue relationships and engagements where the firm:

- Is competent to perform the engagement and has the capabilities, including time and resources, to do so;
- Can comply with relevant ethical requirements; and
- Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity.

QUALITY CONTROL



3. Client acceptance

HKSA 220

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

QUALITY CONTROL



4. Human resources

HKSQC 1

The firm shall establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to:

- Perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and
- Enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

QUALITY CONTROL



4. Human resources

HKSA 220

The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and
- Enable an auditor's report that is appropriate in the circumstances to be issued.

QUALITY CONTROL



5. Engagement performance

HKSQC 1

The firm shall establish policies and procedures designed to provide it with reasonable assurance that

- engagements are performed in accordance with professional standards and applicable legal and regulatory requirements
- that the firm or the engagement partner issue reports that are appropriate in the circumstances.



5. Engagement performance

HKSA 220

The engagement partner shall take responsibility for:

- The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements;
- The auditor's report being appropriate in the circumstances.



5. Engagement performance

HKSA 220

The engagement partner shall take responsibility for:

- The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements;
- The auditor's report being appropriate in the circumstances.

QUALITY CONTROL



5. Engagement performance (Consultation on difficult or contentious matters)

Per HKSA 220, the engagement partner shall:

- Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement
- Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- Determine that conclusions resulting from such consultations have been implemented.

QUALITY CONTROL



5. Engagement performance (Engagement Quality Control Review)

Per HKSQC 1:

The firm shall establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.

- Such policies and procedures shall:
- Require an engagement quality control review for all audits of financial statements of listed entities;
- Set out criteria for all other audits and reviews of historical financial information and other assurance and related services engagements

QUALITY CONTROL



5. Engagement performance (Engagement Quality Control Review)

Per HKSA 220:

For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

- Determine that an engagement quality control reviewer has been appointed;
- Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer;
- Not date the auditor's report until the completion of the engagement quality control review.

QUALITY CONTROL



5. Engagement performance (Engagement Quality Control Review)

Per HKSA 220:

The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

- Discussion of significant matters with the engagement partner;
- Review of the financial statements and the proposed auditor's report;
- Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
- Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

QUALITY CONTROL



5. Engagement performance (Engagement Quality Control Review)

Per HKSA 220:

For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

- The engagement team's evaluation of the firm's independence in relation to the audit engagement;
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and
- Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.

QUALITY CONTROL



6. Monitoring

HKSQC 1

The firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively.

HKSA 220

The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

RESPONSES TO RISKS (HKSA 330)



Risks of material misstatement

- At the financial statement level
- At the assertion level

RESPONSES TO RISKS (HKSA 330)



Response to risks of MM at the FS level

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

**Make sure you practice
past paper questions!**



Day and Night (D&N) is a firm of Certified Public Accountants (Practising) and has recently been approached by A Dummy Limited (ADL) in respect of a change of its statutory auditor. In considering the audit nomination, D&N has been given the audited financial statements for the year ended 31 March 2009 and the unaudited management accounts for the 9-month period ended 31 December 2009, of which certain key figures are detailed as follows:

ADL's statement of comprehensive income

	Unaudited management accounts (9 months ended 31 December 2009)	Audited financial statements (Year ended 31 March 2009)
	HK\$'000	HK\$'000
Revenue	103,985	152,495
Gross profit	30,294	49,493
Profit before tax	10,604	16,956

ADL's statement of financial position

	Unaudited management accounts (at 31 December 2009)	Audited financial statements (at 31 March 2009)
	HK\$'000	HK\$'000
Non-current assets	106,166	94,507
Current assets	78,324	73,611
Current liabilities	(79,302)	(74,247)
Non-current liabilities	(10,958)	(10,245)

ADL is a private company in the business of producing Chinese nutritious food and was established by its owner, Mr. Chan, about twenty years ago. Mr. Chan, aged 70, is still active in running ADL, but he would like to retire in the next two to three years. As none of Mr. Chan's children is interested to succeed him in running the business, he would like to sell ADL to some business partners or investors. Mr. Chan has not yet decided on the most appropriate form of partnership or capitalisation arrangement, but he has plans to utilise any funding injection as the company's working capital. Some institutional investors have already expressed their interest and have made some enquiries about the company's business.

There was a longstanding lawsuit against ADL at the High Court in respect of a violation of some intellectual property rights. ADL lost the case in November 2009 and was ordered to pay compensation of HK\$50,000,000. The compensation has not yet been paid. A provision of HK\$30,000,000 has been made in the financial statements and management accounts. Mr. Chan is in discussion with the lawyers regarding an appeal against the judgement.

Mr. Chan has asked D&N to consider charging the audit fee based on the amount of ADL's reported profit for the year ended 31 March 2010.

Question 1 (12 marks – approximately 22 minutes)

- (a) Discuss the policies and procedures that D&N should have in place in considering ADL's audit nomination. (5 marks)
- (b) Discuss the ethical requirements on D&N in respect of ADL's audit nomination and change in auditor. (7 marks)

Question 2 (9 marks – approximately 16 minutes)

Assume that D&N has accepted the audit engagement. Nancy is D&N's engagement partner on ADL's audit and has made an assessment of the risk of material misstatement at the financial statement level due to fraud as low.

Required:

- (a) Define the risk of material misstatement at the financial statement level. (1 mark)
- (b) As the audit manager of D&N, explain to your trainees:
- (i) how Nancy's assessment of the risk of material misstatement at the financial statement level due to fraud as low was formed; and
 - (ii) D&N's overall response and the relevant audit procedures in response to such assessment. (8 marks)

Question 3 (15 marks – approximately 27 minutes)

- (a) Briefly explain how Nancy should consider the going concern assumption in ADL's financial statements. (2 marks)
- (b) Identify and discuss examples of events or conditions which may invalidate the going concern assumption in ADL's financial statements. (13 marks)

Question 4 (14 marks – approximately 25 minutes)

In the process of finalising the auditor's report on ADL's financial statements for the year ended 31 March 2010, Nancy is considering the effect of subsequent events on ADL's financial statements and the auditor's report.

Required:

- (a) Briefly explain the meaning of subsequent events. (2 marks)
- (b) Discuss the specific audit procedures that Nancy and her engagement team should perform in identifying the events that may require adjustments of ADL's financial statements for the year ended 31 March 2010. (12 marks)

Answer 1(a)

Under HKSQC 1 (Clarified) “Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements”, D&N should have policies and procedures in place for the acceptance of ADL’s audit nomination.

These policies and procedures are to give reasonable assurance that D&N will only undertake engagements where it:

- has considered the Entity’s integrity and does not have information that would lead it to conclude that the Entity lacks integrity (in this context, the Entity refers to Mr. Chan, ADL’s management and ADL’s activities);
- is competent to perform ADL’s audit and has the capabilities, time and resources to do so; and
- can comply with ethical requirements.

Before accepting ADL’s nomination, D&N should obtain the above information and should document how any issues are resolved.

Answer 1(b)

Under the Code of Ethics for Professional Accountants (“Code”) s.210 “Professional Appointment”, D&N should consider whether acceptance of ADL’s audit nomination would create any threats to compliance with the fundamental principles.

For example, the violation of intellectual property rights by ADL may threaten D&N’s compliance with the fundamental principles, such as possible attempts to hide damages to the business through dishonesty and/or accounting irregularities.

Also, Mr. Chan’s requests to D&N of charging the audit fee based on ADL’s profits may threaten D&N’s compliance with the fundamental principles by creating a self-interest threat.

Under the Code s.440 “Changes in a Professional Appointment”, D&N should:

- find out whether the change of auditor has been properly dealt with in accordance with the Companies Ordinance or other legislations; and
- request ADL’s permission to communicate with the outgoing auditor.

If ADL has not properly dealt with the change of auditor, D&N should decline the nomination.

Answer 2(a)

The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Answer 2(b)

Nancy’s assessment was formed based on HKSA 315 (Clarified) “Understanding the Entity and its Environment and Assessing the Risks of Misstatement” which require an understanding of ADL and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

In addition, HKSA 500 (Clarified) “Audit Evidence” requires Nancy to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures.

In general, D&N is not required to give any particular response for a low risk assessment in the risk of material misstatement at the financial statement level, other than maintaining a professional scepticism in gathering and evaluating audit evidence.

HKSA 240 (Clarified) “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements” states that:

Management is in a unique position to perpetrate fraud because of management’s ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Accordingly, even if Nancy assessed the risk of material misstatement at the financial statement level due to fraud as low, D&N should perform audit procedures in responding to the (presumed) risk of management override of controls.

The relevant audit procedures in response to Nancy's assessment are to:

- test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;
- review accounting estimates for biases that could result in material misstatement due to fraud; and
- obtain an understanding of the business rationale of significant transactions that D&N becomes aware of that are outside of ADL's normal course of business or that otherwise appear to be unusual.

Answer 3(a)

Under HKSA 570 (Clarified) "Going Concern", Nancy should consider the appropriateness of ADL's use of the going concern assumption in the preparation of the financial statements when planning and performing audit procedures and in evaluating the results thereof.

Under the going concern assumption, ADL is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.

Accordingly, ADL is expect to realise its assets and discharge its liabilities in the normal course of business.

Answer 3(b)

Examples of events or conditions, which may invalidate the going concern assumption in ADL's financial statements, are as follows:

- (i) Mr. Chan's intention to retire in the next two to three years

As the founder and executive management of ADL, Mr. Chan's expertise and technical know-how may be lost irretrievably as and when he retires from ADL.

Such expertise and technical know-how may be critical to ADL's operation.

- (ii) Further burden on the liquidity risk from the compensation on the lawsuit

Although HK\$30 million out of the total compensation of HK\$50 million has been provided in the accounts, none of the compensation (provided or not provided) has been paid.

It is not certain if ADL has enough cash (or liquid assets) to make the payment.

- (iii) Deterioration of financial performance causing difficulties to attract new business partners or investors which may threaten the continuation of ADL

ADL's gross profit margin has declined from 32.46 percent (y/e 31 Mar 09) to 29.13 percent (9 m/e 31 Dec 09).

ADL's net profit margin has declined from 11.12 percent (y/e 31 Mar 09) to 10.20 percent (9 m/e 31 Dec 09).

- (iv) Depressed financial position hindering inflows of new funds or re-capitalisation which may otherwise threaten the funding of ADL's daily operations

ADL's current ratio has remained below one at 0.99 (on 31 Mar 09 and 31 Dec 09).

Although ADL's net asset has improved from HK\$83,626,000 (at 31 Mar 09) to HK\$94,230,000 (at 31 Dec 09), it will be reduced to HK\$74,230,000 after the payment of HK\$50 million.

- (v) Damages to ADL's name and reputation due to the violation of intellectual property rights

ADL's violation of intellectual property rights is adverse publicity hitting its name and reputation.

Some existing customers of ADL may turn away from buying its products due to the perception that ADL is dishonest and irresponsible.

Answer 4(a)

Under HKSA 560 (Clarified) "Subsequent Events", subsequent events are:

events occurring between the date of financial statements and the date of the auditor's report; and

facts that become known to the auditor after the date of the auditor's report.

Answer 4(b)

The audit procedures of Nancy and her engagement team in respect of subsequent events should cover the period from the date of financial statements (i.e. 31 March 2010) to the date of the auditor's report.

These audit procedures should be performed as near as practicable to the date of the auditor's report.

Examples of these audit procedures are as follows:

- (i) Review the procedures that ADL's management has established to identify subsequent events.
- (ii) Read the minutes of shareholders' and directors' meetings held after 31 March 2010 and inquire about matters discussed at meetings for which minutes are not yet available.
- (iii) Read ADL's latest available management accounts and other related management reports (e.g. budgets and cash flow forecasts).

- (iv) Inquire of ADL's lawyers concerning litigations and claims, particularly in connection with the violation of intellectual property rights lawsuit.
- (v) Inquire of ADL's management as to whether any subsequent events have occurred which might affect the financial statements.

In particular, Nancy and her engagement team should ask about:

- the current status of the lawsuit;
- whether sales of assets or businesses have occurred or are planned (due to Mr. Chan's intention to retire);
- whether the issue of new shares or debentures has been made or is planned;
- whether an agreement to merge or liquidate has been made or is planned; and
- whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, particularly in connection with the validity of the going concern assumption.

Question from QP Module C Jun 2011

You established your own CPA practice six years ago which has now grown into a 15-staff firm. Your firm has been the auditor of an unlisted company, PQR Investment Limited ("PQR"), for six years. The shareholders of PQR have recently injected HK\$90 million of new capital into PQR with a view to acquiring companies in India, Thailand and Japan.

Required:

Discuss what your CPA firm should consider before continuing to serve as the auditor of PQR in the forthcoming year. In particular, your discussion should be put in the context of PQR's circumstances.

(13 marks)

Answer

HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* requires your firm to consider and document certain matters before continuing to serve as PQR's auditor.

Those matters include:

- the integrity of PQR (i.e. its shareholders, directors and management);
- whether your firm is competent to do the work; and
- whether your firm meets ethical requirements in relation to the work.

There is no clear evidence compromising the integrity of PQR even though you may question the source of the new funding into PQR.

As your firm has been the auditor of PQR for six years, competency is not likely to be questioned.

However, the increase of PQR's scale of activities and its forthcoming overseas acquisitions may challenge your firm's competency.

Challenges may include the industries, locations and sizes of those companies being acquired as well as the forms of investments (e.g. equity, debt or quasi-equity) and the availability of properly audited financial statements.

Being associated with PQR (as its auditor) for six years may indicate a close relationship. However, it is not entirely clear if the extent of relationship may pose any familiarity threat to your firm.

You should be satisfied that appropriate procedures regarding the continuance of client relationship and audit engagement with PQR have been followed, and that conclusions reached in this regard are appropriate and have been documented.