

Practice Note 740 Auditor's letter on Continuing Connected Transactions under the Hong Kong Listing Rules

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Practice Note 740

Auditor's letter on Continuing Connected Transactions under the Hong Kong Listing Rules



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AGENDA

- **Part A**
**Practice Note 740 -
Auditor's letter on Continuing Connected
Transactions under the Hong Kong Listing Rules**

- **Part B**
**Examples on Connected Persons and Connected
Transactions**

- **Part C**
Example on De minimis transaction

Part A

Practice Note 740 - Auditor's letter on Continuing Connected Transactions under the Hong Kong Listing Rules

Agenda – Part A

- Background
- PN 740 - Key impacts
- Chronology of events
- Changes in final PN vs. ED PN 740
- Changes in MBLR Ch. 14A / GEM LR Ch. 20 requirements
- Listing Rules – Some key definitions / requirements
- Key requirements under PN 740
- General considerations
- Specific reporting considerations
 - Approval by listed issuer's directors
 - Compliance with listed issuer's pricing policies
 - Entered into in accordance with relevant agreement
 - Transaction amount not exceed the cap
- Reporting and references in annual report
- Other practical considerations
- Action points for auditor
- Action points for listed issuer's management and audit committee

Background

- Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38 issued by The Stock Exchange of Hong Kong Limited ("SEHK")
- Factors that drive the need for the Practice Note ("PN")
 - Lack of current standard or guidance
 - Possible inconsistency in approach (AUP vs. Assurance) in different situations
 - Different interpretation of Hong Kong Listing Rules requirements
 - Addressing the SEHK's expectations
 - Addressing possible gaps between SEHK's expectations and work currently done by auditors
- The PN has been prepared in consultation with the SEHK and staff at the Hong Kong Securities and Futures Commission

Background (cont'd)

- Understand the context
 - MBLR Chapter 14A / GEM LR Chapter 20
 - Protection of minority interests from dominant shareholders and management abuse
 - Disclosure and approval of connected transactions
 - Review and reporting by INEDs and auditors
- Respective roles and responsibilities
 - Each of the following has a different role: -
 - Directors: overall responsible for running the company and looking after shareholders' interests
 - INEDs: independent review of CCT
 - Auditors: independent report on CCT

PN 740 - Key impacts

- Main implications for auditors and listed issuers:
 - Limited assurance engagement and report
 - This may involve change from agreed upon procedures (AUP) engagement to limited assurance engagement (if AUP now being done)
 - Note reference is made to “auditor” because work is done and reported on by the issuer’s auditor, but engagement is not an “audit”
 - Work is separate from the audit of the financial statements, but is complementary in some respects

PN 740 - Key impacts (cont'd)

- Other key impacts on listed issuers and auditors
 - Clarifies auditor's scope of work and matters to be reported
 - Recognises inherent limitations on the auditor's work on completeness of CCT
 - Notes listed issuers' responsibilities including for the completeness of connected transactions and compliance with listing rules relevant to CCT
 - Describes the auditor's responsibilities
 - Provides more guidance to address common issues encountered by auditors
 - Guidance on documentation and evidence required including engagement letter; extent of testing; enquiries (include written representations); form of report (letter); interactions with audit work & with INEDs

Chronology of events

Event	Date
Issuance of exposure draft (ED) of PN 740 for public comments before 31 December 2009	October 2009
Various amendments to the Listing Rules governing the connected transactions	May 2010
Issuance of final PN 740, which is effective for periods ending on or after 31 December 2010 (with early adoption permissible)	June 2010

Changes in final PN vs. ED PN 740

Primarily additional guidance: -

- Elaborates on directors' and listed issuer's responsibilities
- Elaborates on auditor's responsibilities
- Provides additional guidance on materiality and auditor's work on pricing policy
- More closely aligns the wording of report conclusions to the wording of the Listing Rules

Changes in MBLR Ch. 14A / GEM LR Ch. 20 requirements

- May 2010
- Increase the thresholds of and extends the de minimis exemptions
- Clarify the definition of connected person to exclude certain transactions from Listing Rules requirements
- Clarify that the annual review requirements apply to non-exempt continuing connected transactions

Mainly clarification and had no significant
impact on scope of work under PN 740

Listing Rules - Some key definitions

- What is a “continuing connected transaction”?
 - Who/What is a “connected person”?
 - Main Board Listing Rules (“MBLR”) 1.01, 14A.11 & 14A.12 / GEM Listing Rule (“GEM LR”) 1.01, 20.11 & 20.12
 - What is a “transaction”?
 - MBLR 14A.10(13) / GEM LR 20.10(13)
 - What is a “connected transaction”?
 - MBLR 14A.13 / GEM LR 20.13
 - What is a “continuing connected transaction”?
 - MBLR 14A.14 / GEM LR 20.14

NB - Similarities with “related party” under HKAS 24 (but not identical)

Listing Rules - Some key definitions (cont'd)

- Continuing connected transaction (“CCT”) –
Consider some exemptions / waivers
 - MBLR 14A.33 / GEM LR 20.33 – exemptions
e.g. Utilities provided to a connected person, meals consumed by a connected person at a listed issuer’s restaurant of small amount; and some other examples (refer to rules)
 - MBLR 14A.34 / GEM 20.34 – partial exemptions
 - MBLR 14A.42 / GEM LR 20.42 - waivers

Listing Rules - Some key requirements

- Non-exempt CCT
 - MBLR 14A.35 / GEM LR 20.35
 - Written agreement (3 years maximum in general), including basis of calculation of payments
 - Normal commercial terms *
 - Maximum aggregate annual value ("cap")
 - Reporting and announcement requirements
 - Independent shareholders' approval requirements (save where exempt)

* INEDs (but not auditors) to confirm

Listing Rules - Some key requirements (cont'd)

- Annual review of CCT
 - MBLR 14A.37 & 14A.38 / GEM LR 20.37 & 20.38
 - Independent Non-Executive Directors' review
 - Auditor's letter
- Annual report disclosures
 - MBLR 14A.45 / GEM LR 20.45
 - Various details to be disclosed

Key requirements under PN 740

- Conduct a limited assurance engagement in accordance with Hong Kong Standard on Assurance Engagement 3000 "*Assurance engagements other than audits or reviews of historical financial information*"
- Report on the matters in respect of CCT set out in the Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38
- Address auditor's letter to the listed issuer's board of directors
- Consent to provide a copy of auditor's letter to the SEHK
- Reporting matters of governance interest

General considerations

Agenda

- Completeness of connected persons and transactions
- Planning and performing the engagement
 - Terms of engagement
 - Extent of testing and sampling
 - Materiality
 - Interaction with annual audit
 - Auditor's work during hard close / system procedures
 - Risk of fraud or error and skepticism
- Written representations from management
- Communication with those charged with governance

General considerations

Completeness of connected persons and transactions

- Responsibilities for identifying and disclosing all connected persons and transactions rest with the listed issuer's directors
- Inherent limitation - Auditor's work cannot be expected to detect all CCT
- Reliance on management to identify connected persons
- Consistent with what also applies under auditing standards in respect of related party transactions
- Auditor must carry out appropriate work with due care and skepticism

General considerations

Completeness of connected persons and transactions (cont'd)

- Auditor's letter covers those CCT that have been identified by management

For example –

“Due to the nature of connected persons and transactions, it was not practicable for us to determine whether the disclosed continuing connected transactions and the books and records of the Group include all continuing connected transactions. It was impracticable for us to quantify the potential impact of this on the disclosures of continuing connected transactions in the Company's annual report. Accordingly, our report relates solely to the continuing connected transactions that have been disclosed to us and in the books and records of the Group made available to us.”

General considerations

Completeness of connected persons and transactions (cont'd)

- Nevertheless, auditor should during the course of the engagement:
 - Plan and perform the work with an attitude of professional skepticism
 - Consider issuer's internal controls in place to identify connected persons and CCT and omissions
 - Perform modified, extended or additional procedures as appropriate
 - Consider implications on auditor's letter where there are apparent omissions
 - Consider unusual transactions identified (e.g. price, terms and conditions)

General considerations

Completeness of connected persons and transactions (cont'd)

- Transactions between various State-Owned Enterprises ("SOE")
 - Main Board Listing Rule 14A.12A(2) / GEM Listing Rule 20.12A(2)
 - a PRC Governmental Body (defined in Main Board Listing Rule 19A.04 / GEM Listing Rule 25.04) will not be normally treated as a connected person
 - If requested by the SEHK, the listed issuer must make written representation explaining its relationship with the PRC Governmental Body
 - If the SEHK determines that it is a connected person, the listed issuer must agree to comply with any additional obligations arising from such treatment

General considerations

Completeness of connected persons and transactions (cont'd)

- Transactions between various State-Owned Enterprises (“SOE”) (cont'd)
 - Where auditor has concerns, he should discuss with listed issuer
 - If appropriate, request listed issuer to clarify with the SEHK as to whether and extent to which the transactions constitute CCT

General considerations

Completeness of connected persons and transactions (cont'd)

- Practical issue
 - What measures the listed issuer has taken to ensure the completeness of connected persons and transactions?
 - e.g. how did they capture any changes arising from mergers / acquisitions?
 - e.g. how did they determine whether the transactions with SOE constitute CCT?

General considerations

Planning and performing the engagement

- Terms of engagement
 - Mutual agreement on terms of engagement
 - Example engagement terms – Appendix 3 to the PN
 - Consider including relevant terms in an audit engagement letter or issuing a separate engagement letter

- Practical issue

- As PN 740 is newly issued, likely new / revised engagement letter is required this year

General considerations

Planning and performing the engagement (cont'd)

- Extent of testing and sampling
 - A limited assurance engagement ordinarily consists of observation, inquiry and other analytical review procedures
 - Under the PN, reporting on CCT envisages sample test of transactions
 - Auditor uses professional judgment as to which means or combination of means to be used for determining the sample and sample size
 - Sampling method and size may be different between reporting on CCT under PN 740 vs. work done in respect of RPT during the financial statements audit and may be influenced by level of “materiality”

General considerations

Planning and performing the engagement (cont'd)

- Extent of testing and sampling (cont'd)
 - A combination of testing of internal controls and substantive testing
 - Depending on the effectiveness of the related internal controls (if any), it may be possible to consider reducing extent of substantive testing
 - Auditor alone selects items for testing

Practical issue

- How does an auditor determine an appropriate sample size for substantive testing?
 - Financial statement audit as a whole vs. component
 - Positive assurance vs. negative assurance
 - How much can an auditor rely on the control testing results from the financial statement audit?

General considerations

Planning and performing the engagement (cont'd)

- Materiality
 - Materiality for CCT reporting vs. materiality for financial statements audit may not necessarily be the same
 - How should the materiality for the audit of the financial statements compare to materiality level for CCT?
 - e.g. say, disclosed CCT are HK\$10 million in aggregate vs. net profit of the company of HK\$200 million

Practical issue

- Component materiality may be lower vs. for financial statements as a whole
- Impacts on extent of procedures

General considerations

Planning and performing the engagement (cont'd)

- Materiality (cont'd)

Evaluating misstatements:-

- Consider quantity (amount) and quality (nature) of misstatements
 - e.g. A breach of permitted cap as a result of an immaterial understatement in CCT say, HK\$1,000 (may be material based on qualitative factors even if not material based on quantitative factors)
- Factors to be considered
 - Cause of misstatement (e.g. failure in internal controls system)
 - Management's explanation
 - Likely impact (e.g. result in non-compliance with Listing Rules requirements)

General considerations

Planning and performing the engagement (cont'd)

- Materiality (cont'd)

- Practical issue
 - Should auditor use different level of materiality for reporting on the 4 different listing rules requirements?
 - Should auditor use different level of materiality for different types of CCT?

Judgment required

General considerations

Planning and performing the engagement (cont'd)

- Interaction with annual audit
 - “Related party” defined in HKAS 24 “Related Party Disclosures” not identical to “Connected person” defined in listing rules
 - However, issues encountered are broadly similar
 - Consider procedures performed and findings in annual audit in respect of related parties and transactions

General considerations

Planning and performing the engagement (cont'd)

- Consider whether to plan and perform some of the auditor’s work on CCT during hard close / systems procedures
 - Obtain understanding and perform tests of process / internal controls system in place to identify CCT and monitor compliance with related
 - Identify new connected persons and transactions which may impact on the scope of auditor’s work
 - Communicate with management of any internal control weakness so that management may take necessary action at an early stage
 - Obtain details of INED’s review, if any

- | |
|---|
| <ul style="list-style-type: none">▪ Practical issue<ul style="list-style-type: none">▪ Consider results of testing of related party disclosures |
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General considerations

Planning and performing the engagement (cont'd)

- Consider risk of fraud and error. Use professional skepticism.
 - Fraud can be committed through management overriding controls
 - e.g. omitted or concealed CCT (e.g. that favour management / other connected persons)
 - e.g. altering books and records
 - Due to inherent limitation, it is difficult for auditor to determine the completeness of CCT
 - Auditor should consider “unusual” transactions that come to his attention

General considerations

Planning and performing the engagement (cont'd)

- Consider extent of reliance on internal auditors' work and results, if any
 - Objectivity of internal audit function
 - Objectives of internal auditors' work
 - Extent and scope of internal auditors' work
 - Internal auditors' work unlikely to be sole basis for auditor's conclusion(s)

General considerations

Written representations from management

- Example representation letter – Appendix 4 to the PN
- Representations from directors include -
 - Management's responsibility on completeness of disclosed CCT
 - Management's responsibility on internal controls over identification, record and authorization of all connected persons and transactions
 - Listed issuer's compliance with the applicable reporting, approval and announcement requirements set out in the Listing Rules
 - Listed issuer's compliance with the MBLR 14A.38 / GEM LR 20.38 requirements (Auditor may not be able to issue unqualified opinion if management is unable to confirm the compliance)
 - Management's knowledge of any fraud and assessment of its impact on the listed issuer's books and records
 - Management's assessment on the effects of the uncorrected misstatements, which are immaterial both individually and in the aggregate

General considerations

Written representations from management (cont'd)

- Obtain representations in respect of INEDs' confirmation as to listed issuer's compliance with Main Board Listing Rule 14A.37 / GEM Listing Rule 20.37 requirements
- If INEDs confirmation not yet issued – consider alternatives
- May request other representations where appropriate
 - For example, in respect of any relationship where it may be unclear if "connected"

General considerations

Communication with those charged with governance

- Interact with independent non-executive directors' ("INEDs")
 - INEDs required to carry out a separate review of CCT
 - Auditors' work under the PN not intended as basis for INEDs' review
- Any issues and outcome identified by auditor and INEDs may be of relevance to each other
 - For example, where INEDs conclude that the CCT are not entered into on normal commercial terms, it may have implication on auditor's reporting on compliance with listed issuer's pricing policies
- Inform those charged with governance of the uncorrected misstatements

General considerations

Communication with those charged with governance (cont'd)

- Consider communicating other significant matters with appropriate management
 - e.g. in respect of any internal controls weakness or errors
 - e.g. in respect of CCT in breach of cap
 - e.g. in respect of fraud or concealment of CCT

- Practical issue
 - Timing – auditor's letter: 10 days prior to bulk printing of annual report

Specific reporting considerations

- Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38
- Each year the auditors must provide a letter to the listed issuer's board of directors confirming that the CCT":
 - 1) have received the approval of the listed issuer's board of directors;
 - 2) are in accordance with the pricing policies of the listed issuer if the transactions involve provision of goods or services by the listed issuer;
 - 3) have been entered into in accordance with the relevant agreement governing the transactions; and
 - 4) have not exceeded the cap disclosed in previous announcement(s).
- Matters to be reported will be subject to materiality

Specific reporting considerations

1) Approval by listed issuer's directors

- Listing rules require auditor to confirm that -
"the CCT have received the approval of the listed issuer's board of directors"
- Obtain appropriate and sufficient evidence in respect of the approval of issuer's board of directors on CCT
 - For example, minutes of Board of Directors' meetings, management written representations, etc.

Specific reporting considerations

1) Approval by listed issuer's directors (cont'd)

- Practical issue
 - Approval is required for each continuing connected transaction?
 - Approval in advance or at the end of the financial period?
- Example report conclusion -
"nothing has come to our attention that causes us to believe that the disclosed continuing connected transactions have not been approved by the Company's board of directors."

Specific reporting considerations

2) Compliance with listed issuer's pricing policies

- Listing rules require auditor to confirm that -
"the CCT are in accordance with the pricing policies of the listed issuer if the transactions involve provision of goods or services by the listed issuer."
- Based on sample testing and other procedures
- If there are clear and quantitative pricing terms
 - For example, a standard unit price or reference to a specific price list
 - Compare the pricing terms with the prices for a sample of CCT
 - Evaluate any discrepancy identified, if any, in sample CCT selected for testing and impact on overall conclusion or additional testing etc.

Specific reporting considerations

2) Compliance with listed issuer's pricing policies (cont'd)

■ Practical issue

- How would the auditor deal with a discrepancy?
 - e.g. if net aggregate difference is not material, should auditor issue unqualified report even if net amount comprises of large "understatements" and "overstatements"?
 - e.g. How might a small amount of difference be material?

Specific reporting considerations

2) Compliance with listed issuer's pricing policies (cont'd)

- Qualitative or judgmental pricing policies
 - For example, reference to "market value", "arm's length", "reasonableness", etc
 - Auditor should consider to compare the price for CCT to the price for comparable transactions with non-connected persons
 - Management to identify transactions which are comparable
 - How has management determined / agreed pricing and terms?
 - Comparable transactions may not be identical to the CCT in all respects
 - Auditor should communicate with INEDs at an early stage as to how INEDs are satisfied with the compliance with pricing terms being on "normal commercial terms" etc

Specific reporting considerations

2) Compliance with listed issuer's pricing policies (cont'd)

- Practical issue
 - What should the auditor do if no comparable transactions can be identified?
 - Auditor may consider setting an expected range of prices and comparing against the price terms / pricing policy of the CCT

Specific reporting considerations

2) Compliance with listed issuer's pricing policies (cont'd)

- Auditor may consider comparing the actual price charged for CCT against auditor's expected price / range of prices
- Example report conclusion –
“for transactions involving the provision of goods or services by the Group, nothing has come to our attention that causes us to believe that the prices charged were not, in all material respects, in accordance with the pricing policies of the Company”
- Auditor's conclusions are drawn in the context of primarily
 - Evaluating matters in respect of prices charged
 - Evaluating compliance with the listed issuer's pricing policies
 - In light of the guidance set out in the PN in this regard

Specific reporting considerations

3) Entered into in accordance with relevant agreement

- Listing rules require auditor to confirm that -
“the CCT have been entered into in accordance with the relevant agreement governing the transactions.”
- Based on sample testing and other procedures
- Auditor’s work would ordinarily focus on
 - existence of relevant agreement; and
 - compliance with pricing terms set out in the agreement

Specific reporting considerations

3) Entered into in accordance with relevant agreement (cont'd)

- Auditor’s procedures may include:
 - Making enquiries of appropriate personnel of listed issuer
 - Consider enquiries of non-financial personnel
 - Checking to signed delivery note / acknowledgement of receipt for goods/services delivery
 - Similar guidance that deal with prices of goods/services provided by the listed issuer would typically apply
- May be difficult to assess whether all obligations and terms in the relevant agreement are fulfilled
 - For example, auditor may lack expertise in technical product specifications, difficult to assess whether all obligations at different stages are fulfilled, etc.
 - Focus on (1) existence of agreement; (2) pricing aspects; (3) consider making enquiries of non-financial personnel

Specific reporting considerations

3) Entered into in accordance with relevant agreement (cont'd)

- Example report conclusion –

"nothing has come to our attention that causes us to believe that the transactions were not entered into, in all material aspects, in accordance with the relevant agreements governing such transactions"

Specific reporting considerations

4) Transaction amount not exceed the cap

- Listing rules require auditor to confirm that -
"the CCT have not exceeded the cap disclosed in previous announcement(s)."
- Compare the aggregate amounts of CCT to the respective cap
- Management to identify the relevant announcement(s) in which the cap is disclosed

Specific reporting considerations

4) Transaction amount not exceed the cap (cont'd)

- Compare the disclosure of CCT in annual report to previous announcement(s) to identify any apparent omission in disclosure
 - In case the transaction amount exceeds the cap, consider when assessing materiality of the impact.
 - Investigate reasons
 - Consider internal controls in place to monitor whether the transaction amount of CCT has exceeded the cap
 - Consider actions taken by management, e.g. communications with INEDs and / or the SEHK
- Practical issue
 - How much would the CCT need to exceed the cap to cause the auditor to issue qualified letter?
 - Consider qualitative and quantitative factors

Specific reporting considerations

4) Transaction amount not exceed the cap (cont'd)

- Example report conclusion –
“with respect to the aggregate amount of [each of] the continuing connected transactions set out in the attached list of continuing connected transactions, nothing has come to our attention that causes us to believe that the disclosed continuing connected transactions have exceeded the maximum aggregate annual value disclosed in the previous announcement(s) dated [relevant date(s)] made by the Company in respect of [each of] the disclosed continuing connected transactions.”

Reporting and references in annual report

- Example unqualified auditor's letter – Appendix 2 to the PN
 - Main Board Listing Rule 14A.38 / GEM Listing Rule 20.38 – issued 10 business days before bulk printing of annual report
- Where unable to issue an unqualified conclusion, advise management to discuss with the SEHK the extent of impact on disclosures

Reporting and references in annual report (cont'd)

- Appropriate references to auditor's work in the annual report, for example:
 - *The Company's auditor was engaged to report on the Group's continuing connected transactions in accordance with Hong Kong Standard on Assurance Engagements 3000 "Assurance Engagements Other Than Audits or Reviews of Historical Financial Information" and with reference to Practice Note 740 "Auditor's Letter on Continuing Connected Transactions under the Hong Kong Listing Rules" issued by the Hong Kong Institute of Certified Public Accountants. The auditor has issued their unqualified letter containing his findings and conclusions in respect of the continuing connected transactions disclosed by the Group in page [] of the Annual Report in accordance with [Main Board Listing Rule 14A.38][GEM Listing Rule 20.38]. A copy of the auditor's letter has been provided by the Company to The Stock Exchange of Hong Kong Limited*
- Consider consistency and appropriateness of the disclosures in annual report

Other practical considerations

- Timing for issuing auditor's letter may have implications on
 - Systems testing phase vs. "year end" work phase
 - Discussion with and the confirmation of INEDs' review
 - Timing of receipt of the management representation letter
- Inconsistent disclosure or inappropriate references in annual report
- Documentation and evidence

Action points for auditor

- Plan your work in light of PN 740
 - Resources, timing, approach, extent of procedures, costs
- Update / renew engagement letter terms
- Upfront discussion with listed issuer's management and audit committee, consider discussing:-
 - Key impacts of PN 740
 - AUP changed to limited assurance
 - Inherent limitations of auditor's work under this PN 740
 - Consistent expectation from SFC and SEHK
 - Management responsibilities

Action points for auditor (cont'd)

- Upfront discussion with listed issuer's management and audit committee, consider discussing:- (cont'd)
 - Process / internal controls system that exists to identify and capture all CCT and monitor compliance with the related Listing Rules requirements
 - Timing of test work
 - Determine sample sizes
 - Timing of provision of required books and records and written representations
 - Revised references to auditor's letter included in annual report
- Consider discussing with INEDs as to their separate review

Action points for listed issuer's management and audit committee

- Initiate discussions
 - e.g. management, audit committee and CFO with auditor at planning stage
- Understand timing
 - Auditors' testing (e.g. systems), representation letter (e.g. 10 days before bulk printing), INEDs' confirmation
- Discuss updated engagement terms and costs
- Provide auditor with all required information within agreed timeframe
 - Amounts, agreements, pricing policy, comparable transactions (where relevant), written representation

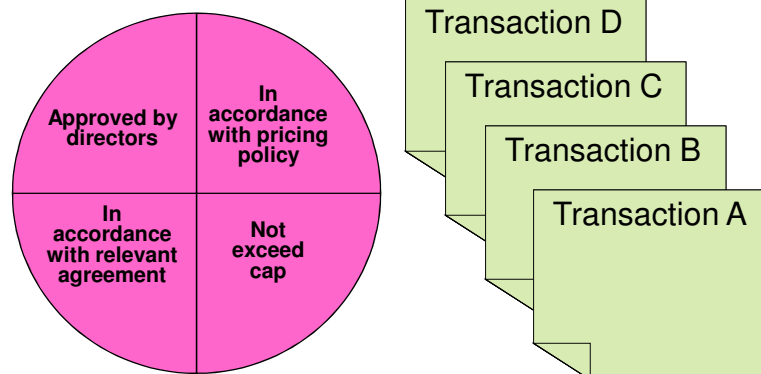
Action points for listed issuer's management and audit committee (cont'd)

- Update review of internal controls system, where necessary, to ensure all connected transactions are recorded effectively *
- Consider requesting INEDs to conduct their separate review as early as possible (as their conclusions will also be considered for auditor's reporting) *
- Consider need for revised references in the annual report

* These are not "new" but generally should be considered every year

Materiality

Should different level of materiality be used?



Materiality

Where different amount of discrepancies are found (for examples):

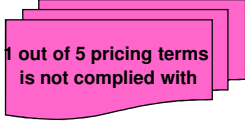
(A) It was found that the CCTs, totalling HK\$10M, have exceeded the cap by HK\$1,000. The breach may be immaterial but non-compliant with listing rules requirement. Should the auditor's letter be qualified accordingly?

Over the Cap by HK\$1,000



(B) It was found that 1 out of 5 pricing terms have not been complied with for a CCT involving provision of goods by the listed issuer. Is it material breach? Should the auditor's letter be qualified accordingly?

1 out of 5 pricing terms is not complied with




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Materiality

Where different amount of discrepancies are found (for examples):

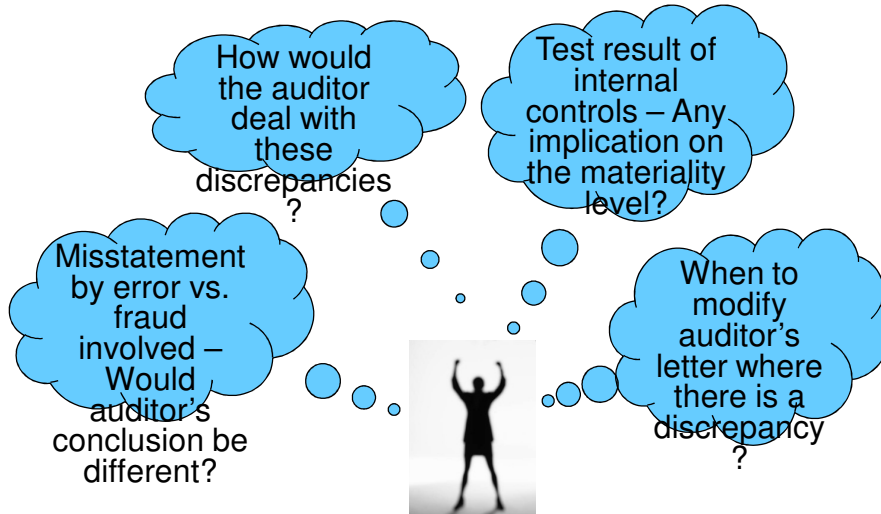
(C) It was found that some CCTs have significantly exceeded the cap while some CCTs were significantly below the cap. The net aggregate difference is not material. Should the auditor's letter be qualified accordingly?

Over the Cap by HK\$1,000,000
Below the Cap by HK\$900,000



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Materiality – Judgment required



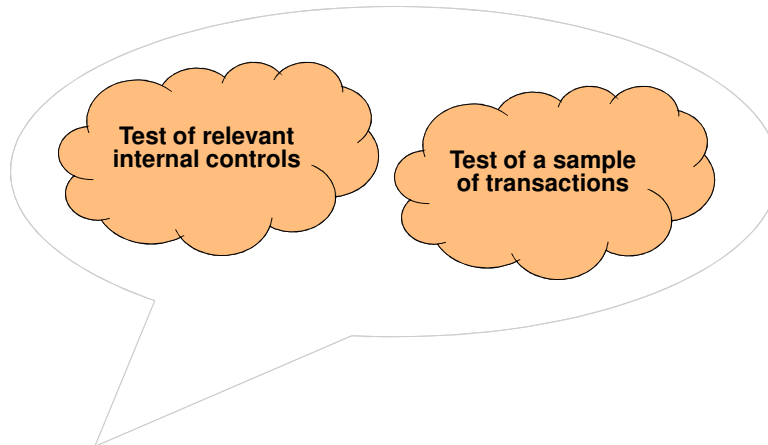
Extent of sampling and testing

- Inquiries
- Analytical procedures
- Other review procedures

PN 740
Test of a sample of transactions

Limited assurance engagement

Extent of sampling and testing

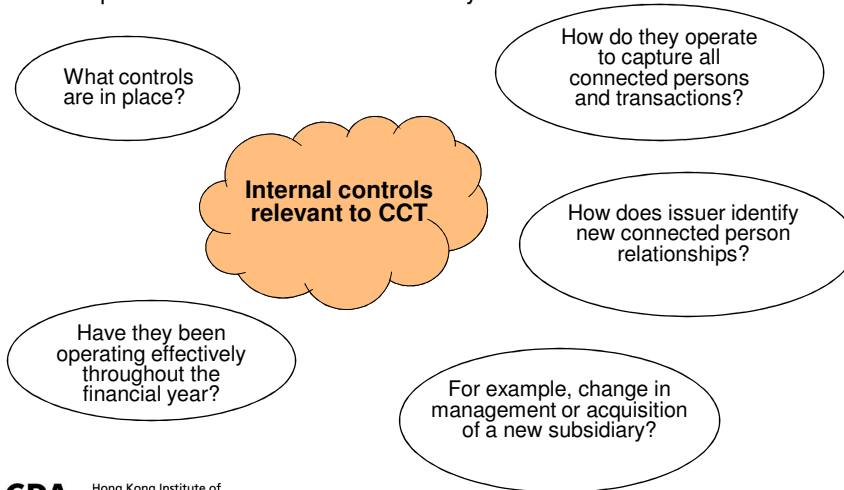


Extent of sampling and testing

- Inherent risk concerning:
- Completeness of connected persons and transactions
- Fraud risk (management override of controls)
- Not performing test of controls – may not be sufficient to reduce risk of material misstatement to an acceptable level
- Auditor should give consideration to the listed issuer's internal controls in place to identify additional connected persons / transactions as part of reporting under PN 740

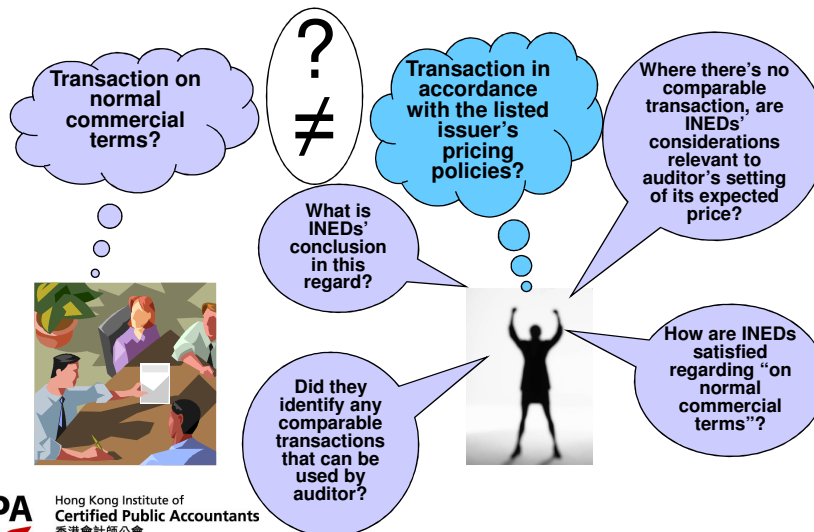
Extent of sampling and testing

Examples of consideration to be taken by auditor



Auditor's reporting on pricing policies

Interaction between auditor's reporting and INEDs' review

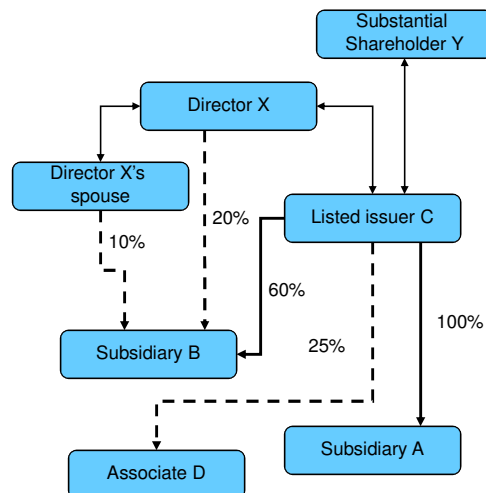


Part B

Examples on Connected Persons and Connected Transactions

Who are the connected persons?

- Substantial shareholder Y?
- Director X?
- X's spouse?
- Subsidiary A?
- Subsidiary B?
- Associate D?

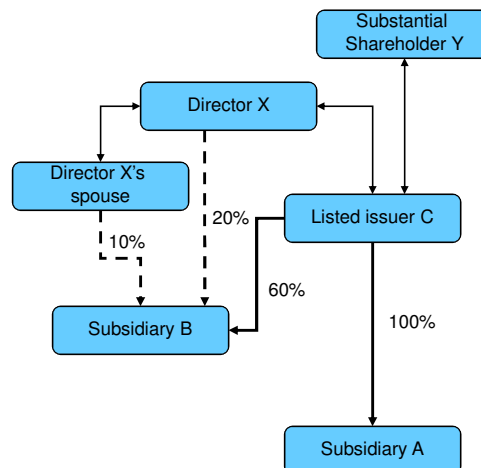


Who are the connected persons? (Draft suggested answers)

- **Substantial shareholder Y?**
- Yes, MBLR 14A.11(1) / GEM LR 20.11(1)
- **Director X?**
- Yes, MBLR 14A.11(1) / GEM LR 20.11(1)
- **X's spouse?**
- Yes, MBLR 14A.11(4) & 1.01(a)(i) / GEM LR 20.11(4) & 1.01(a)(i)
- **Subsidiary A?**
- No, assumed 100% wholly-owned subsidiary with no other relationships
- MBLR 14A.11(5) / GEM LR 20.11(5)
- **Subsidiary B?**
- Yes, the aggregate of director X's and his spouse's interest $\geq 10\%$
- MBLR 14A.11(5) / GEM LR 20.11(5)
- Intra-group transactions exemption not apply because:
 - being an associate of a person connected at issuer level
 - controlling interest in aggregate $> 10\%$
- **Associate D?**
- No, where D is connected by virtue of C's 25% shareholding of the company and no other arrangement is entered into by or no other relationship is with any connected person of C

What are connected transactions?

- Management fee paid to Y?
- Salaries paid to X?
- Consumption of utilities by B that is supplied by C?



What are connected transactions? (Draft suggested answers)

- **Management fee paid to Y?**
- Possibly, connected person by virtue of being substantial shareholder of the listed issuer (MBLR 14A.11(1) / GEM LR 20.11(1))
- But if it's sharing of administrative services at cost and on a fair & equitable basis, exempted transactions under MBLR 14A.31(8) / GEM LR 20.31(8)
- Also subject to de minimis transaction exemption provided on normal commercial terms (MBLR 14A.31(2) / GEM LR 20.31(2))
- **Salaries paid to X?**
- Possibly exempted connected transaction (MBLR 14A.31(6) / GEM LR 20.31(6))
- But subject to MBLR 13.68 / GEM LR 17.90 - independent shareholders' approval may be required
- **Consumption of utilities by B that is supplied by C?**
- Possibly, because the aggregate interest of X and X's spouse
- But if it meets the consumer goods/services provision under MBLR 14A.31(7) / GEM LR 20.31(7), exempted transaction
- The provision includes a number of conditions: e.g.
 - for own private consumption but not be used in connected with any business;
 - consumed in the same state as when they were acquired;
 - of a total consideration / value less than 1% of the total revenue / purchases.
- Also subject to de minimis transaction exemption provided on normal commercial terms (MBLR 14A.31(2) / GEM LR 20.31(2))

Part C

Example on De minimis transaction

De minimis transaction

(MBLR 14A.31(2) & 14A.32 / GEM LR 20.31(2) & 20.32)

Category	Each of the size test * (except for the profits test)	Additional criteria	Exempt from the following LR requirement		
			Reporting (note 1)	Announcement (note 1)	Independent shareholders' approval
(A)	< 0.1%	No additional criteria	√	√	√
(B)	< 1%	Being connected transaction only because it involves a person who is a connected person of the issuer by virtue of its/his relationship(s) with the issuer's subsidiary(ies).	√	√	√
(C)	< 5%	Total consideration < HK\$1M	√	√	√
(D)	< 5%	No additional criteria			√
(E)	< 25%	Total consideration < HK\$10M			√

Note 1 – In accordance with MBLR 14A.33(3) & 14A.34 / GEM LR 20.33(3) & 20.34, where the transactions constitute continuing connected transactions, they will be exempted from the annual review requirements (including auditor's letter) set out in MBLR 14A.37 to 14A.40 / GEM LR 20.37 to 20.40.

* Including Assets ratio, Consideration ratio, Revenue ratio and Equity Capital ratio

De minimis transaction (Answers)

What are the implications of the following connected transactions?

- An example of the following issuer, the listed issuer has:
 - Revenue = HK\$200M
 - Profits = HK\$100M
 - Assets = HK\$3,000M
 - Total market capitalisation = HK\$1,500M
 - Equity capital issued = HK\$300M

Attributable to the CCT Transactions	Revenue (HK\$)	Profits (HK\$)	Assets (HK\$)	Consideration (HK\$)	Equity capital issued	De minimis transaction?
X (acquisition of a company)	10M 5%	2M 2%	100M 3.33%	8M 0.53%	4M 1.33%	Category E
Y (sales of goods)	150,000 0.08%	50,000 0.05%	Nil 0%	150,000 0.01%	Nil 0%	Category A
Z (disposal of an asset)	30M 15%	15M 15%	28M 0.93%	35M 2.33%	5M 1.67%	Not a de minimis transactions

Panel Discussion & Q & A Session